Rebooting Europe

How to fix Europe's monetary union

Views of leading economists

Edited by Richard Baldwin
and Francesco Giavazzi

CEPR
REBOOTING EUROPE

A VoxEU.org Book

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CEPR Press

Centre for Economic Policy Research
2nd Floor
33 Great Sutton Street
London, EC1V 0DX
UK

Tel: +44 (0)20 7183 8801
Email: cepr@cepr.org
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About the contributors

Richard Baldwin is Professor of International Economics at the Graduate Institute, Geneva since 1991, a part-time visiting research professor at the University of Oxford since 2012, Director of CEPR since 2014, and Editor-in-Chief of Vox since he founded it in June 2007. He was Co-managing Editor of the journal *Economic Policy* from 2000 to 2005, Policy Director of CEPR from 2006 to 2014, and Programme Director of CEPR's International Trade programme from 1991 to 2001. Before that he was a Senior Staff Economist for the President's Council of Economic Advisors in the Bush Administration (1990-1991), on leave from Columbia University Business School where he was Associate Professor. He did his PhD in economics at MIT with Paul Krugman and has published a half dozen articles with him. He was visiting professor at MIT in 2002/03 and has taught at universities in Australia, Italy, Germany and Norway. He has also worked as consultant for the numerous governments, the Asian Development Bank, the European Commission, OECD, World Bank, EFTA, and USAID. The author of numerous books and articles, his research interests include international trade, globalisation, regionalism, and European integration.

Thorsten Beck is Professor of Banking and Finance at Cass Business School in London. He was Professor of Economics and founding chair of the European Banking Center at Tilburg University from 2008 to 2013. Previously he worked in the research department of the World Bank and has also worked as consultant for – among others - the IMF, the European Commission, and the German Development Corporation. His research and policy work has focused on international banking and corporate finance and has been published in *Journal of Finance*, *Journal of Financial Economics*, *Journal of Monetary Economics* and *Journal of Economic Growth*. His research and policy work has focused on Eastern, Central and Western Europe, Sub-Saharan Africa and Latin America. He is also Research Fellow at CEPR and a Fellow at the Center for Financial Studies in

Frankfurt. He studied at Tübingen University, Universidad de Costa Rica, University of Kansas and University of Virginia.

Agnès Bénassy-Quéré is a Professor at the Paris School of Economics - University of Paris 1 Panthéon Sorbonne, and the Chair of the French Council for Economic Analysis. She worked for the French Ministry of economy and finance, before moving to academic positions successively at Universities of Cergy-Pontoise, Lille 2, Paris-Ouest and Ecole Polytechnique. She also served as a Deputy Director and as a Director of CEPII and is affiliated with CESIfo. She is a Member of the Commission Economique de la Nation (an advisory body to the Finance Minister) and of the Cercle des Economistes, and a columnist at France Culture. She is a former member of the Shadow ECB Council. Her research interests focus on the international monetary system and European macroeconomic policy.

Peter Bofinger is Professor for Monetary Policy and International Economics at the University of Wuerzburg, member of the German Council of Economic Experts and a Research Fellow at the Centre for Economic Policy Research (CEPR). He received his doctorate from Saarland University. Previously he was economist at the Bundesbank, visiting scholar at the Federal Reserve Bank of St. Louis and at the IMF, and Professor at the Universities of Kaiserslautern and Konstanz. He is author of textbooks on macroeconomics and monetary economics (Monetary Policy: Goals, Institutions, Strategies, and Instruments) as well as general interest books on economic issues.

Giancarlo Corsetti is Professor of Macroeconomics at the University of Cambridge. His main field of interest is international economics and open-economy macro. His main contributions to the literature include models of the international transmission mechanisms and optimal monetary policy in open economies; theoretical and empirical studies of currency and financial crises and their international contagion; models of international policy cooperation and international financial architecture; quantitative and empirical analyses of the multiplier and fiscal policy. He has published articles in many international journals including *American Economic Review*, *Brookings Papers* *on Economic Activity*, *Economic Policy*, *Journal of Monetary Economics*, *Quarterly Journal of Economics*, *Review of Economic Studies*, and the *Journal of International Economics*. He is currently co-editor of the *Journal of International Economics*. Giancarlo Corsetti is a Research Fellow at CEPR, where he was previous Director of the International Macroeconomics Programme. He has also been a research consultant to the European Central Bank and the Bank of England.

Paul De Grauwe is a Professor at the London School of Economics, having been Professor of International Economics at the University of Leuven, Belgium and a visiting scholar at the IMF, the Board of Governors of the Federal Reserve, and the Bank of Japan. He was a member of the Belgian parliament from 1991 to 2003. His research interests are international monetary relations, monetary integration, foreign-exchange markets, and open-economy macroeconomics. His books include *The Economics of Monetary Union*, *International Money. Post-war Trends and Theories*, and *The exchange rate in a behavioural finance framework*. He obtained his Ph.D from the Johns Hopkins University in 1974 and honoris causae of the University of Sankt Gallen (Switzerland), of the University of Turku (Finland), and the University of Genoa. He is a CEPR Research Fellow.

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. He is a CEPR Research Fellow, and a fellow of the American Academy of Arts and Sciences, and the convener of the Bellagio Group of academics and economic officials. In 1997-98 he was Senior Policy Advisor at the International Monetary Fund. He was awarded the Economic History Association's Jonathan R.T. Hughes Prize for Excellence in Teaching in 2002 and the University of California at Berkeley Social Science Division's Distinguished Teaching Award in 2004. He is also the recipient of a doctor honoris causa from the American University in Paris. His research interests are broad-ranging, and include exchange rates and capital flows, the gold standard and the Great Depression; European economics, Asian integration and development with a focus on exchange rates and financial markets, the impact of China on the international economic and financial system, and IMF policy, past, present and future.

Lars P. Feld is the director of the Walter Eucken Institute in Freiburg and Professor for Economic Policy at the University of Freiburg. At the Centre for European Economic Research (ZEW), he is involved as Research Associate in the research department of Corporate Taxation and Public Finance. In 2011, Professor Feld was appointed to the German Council of Economic Experts. He also is a member of the Scientific Advisory Board to the German Federal Finance Ministry; a member of the Kronberger Kreis; and member of the German Academy of Sciences Leopoldina. In 2007, he was appointed as expert for the Commission of the Bundestag and Bundesrat for modernising fiscal relations between the federal and state governments in the Federal Republic of Germany (Federalism Commission II). He is managing editor for the Perspektiven der Wirtschaftspolitik, a journal published by the German Economic Association. From 2007 until 2009, he served as president of the European Public Choice Society. Having studied Economics at the University of Saarland from 1987 until 1993, he received his doctorate (1999) and his habilitation (2002) at the University of St. Gallen. Between 2002 and 2006 he was Professor of Economics at the University of Marburg and then worked as Professor of Finance at Heidelberg University. In 1996, he was awarded the Wicksell Prize by the European Public Choice Society, in 1999, he received the Young Scholar Award and in 2001 the Best Paper Prize, both awarded by the International Institute of Public Finance (IIPF). In 2008 he was presented the Excellence in Refereeing Award by the American Economic Review and in 2005 he was listed among the top ten German young economists by the business magazine Wirtschaftswoche. His research interests cover several areas of Public Finance, New Political Economy, Economic Analysis of Law and Economic Psychology.

Jeffrey Frankel is Harpel Professor at Harvard University's Kennedy School of Government. He directs the program in International Finance and Macroeconomics at the National Bureau of Economic Research, where he is also on the Business Cycle Dating Committee, which officially declares U.S. recessions. Professor Frankel served at the Council of Economic Advisers in 1983-84 and 1996-99; he was appointed by Bill Clinton as CEA Member with responsibility for macroeconomics, international economics, and the environment. Before moving east, he had been Professor of Economics at the University of California, Berkeley, having joined the faculty in 1979. He is an external member of the Monetary Policy Committee of Mauritius and serves on advisory panels for the Federal Reserve Bank of New York, the Bureau of Economic Analysis, and the Peterson Institute for International Economics. In the past he has visited the IIE, the IMF, and the Federal Reserve Board. His research interests include currencies, crises, commodities, international finance, monetary and fiscal policy, trade, and global environmental issues. He was born in San Francisco, graduated from Swarthmore College, and received his Economics PhD from MIT.

Francesco Giavazzi is Professor of Economics at Bocconi University, where he was Deputy Rector from 2001-03. He is a CEPR Research Fellow and a Research Associate of NBER. He chairs the Scientific committee of CEPII and was a member of the Strategic Committee of the Agence France Trésor. From 1991 to 1999 he was an editor of the *European Economic Review*. From 1992 to 1994 he was a Director General of the Italian Treasury responsible for debt management and privatisations, and a member of the Council of Economic Advisers to the Italian Prime Minister (1998-99). In 2012 he produced, at the request by Prime Minister Monti, a report on state subsidies to private enterprises, which has become part of the government plan for spending cuts. He graduated in electrical engineering from the Politecnico of Milan in 1972 and obtained a PhD in economics from MIT in 1978.

Daniel Gros is the Director of the Centre for European Policy Studies (CEPS) in Brussels. Originally from Germany, he attended university in Italy, where he obtained a *Laurea in Economia e Commercio*. He also studied in the United States, where he earned his M.A. and PhD (University of Chicago, 1984). He worked at the International Monetary Fund, in the European and Research Departments (1983-1986), then as an Economic Advisor to the Directorate General II of the European Commission (1988-1990). He has taught at the College of Europe (Natolin) as well as at various universities across Europe. He worked at CEPS from 1986 to 1988, and has worked there continuously since 1990. His current research concentrates on the impact of the euro on capital and labour markets, as well as on the international role of the euro, especially in Central and Eastern Europe. He also monitors the transition towards market economies and the process of enlargement of the EU towards the east (he advised the Commission and a number of governments on these issues). He was advisor to the European Parliament from 1998 to 2005, and member of the *Conseil Economique de la Nation* (2003-05); from 2001 to 2003, he was a member of the *Conseil d'Analyse Economique* (advisory bodies to the French Prime Minister and Finance Minister). Since 2002, he has been a member of the Shadow Council organised by Handelsblatt; and since April 2005, he has been President of San Paolo IMI Asset Management. He is editor of *Economie Internationale* and editor of *International Finance*. He has published widely in international academic and policy-oriented journals, and has authored numerous monographs and four books.

Refet S. Gürkaynak is professor of economics and chair of the Economics Department at Bilkent University and a CEPR Research Fellow. He has a BA from Bilkent and a PhD from Princeton Universities, both in economics. Prior to his current position he was an economist at the Monetary Affairs Division of the Federal Reserve Board. He is a frequent consultant to various central banks. Gürkaynak's research interests are monetary economics, financial markets and international economics. In particular, he has worked on extracting information from asset prices that help answer monetary policy related questions. His research along these lines has been published in journals such as *Journal of Monetary Economics*, *Review of Economics and Statistics* and *American Economic Review*. He is currently on editorial boards of *Economic Policy* and *Journal of Monetary Economics*. He has been the recipient of awards from the Central Bank of Turkey, the European Central Bank and the Turkish Academy of Sciences.

Yuemei Ji did her undergraduate studies in economics at Fudan University in Shanghai and obtained her PhD in economics from the University of Leuven in March 2011. She is currently a lecturer at Brunel University. Her areas of expertise are international financial economics and the economics of education.

Sebnem Kalemli-Ozcan is Neil Moskowitz Endowed Professor of Economics at University of Maryland, College Park. She is a Research Associate at the National Bureau of Economic Research (NBER) and a CEPR Research Fellow. A native of Turkey, Professor Kalemli-Ozcan received her BS in Economics from the Middle East Technical University in 1995 and her PhD in Economics from Brown University in 2000. She was a Duisenberg Fellow at the European Central Bank in 2008 and held a position as lead economist/advisor for the Middle East and North Africa Region at the World Bank during 2010-2011. She was selected as one of the three Senior Research Fellows of the IMF in 2013. She has held positions as a Visiting Professor at Bilkent University, Koc University and at Harvard University. Professor Kalemli-Ozcan has published extensively in the areas of international finance, international development and applied growth theory in journals such as *American Economic Review*, *Journal of Finance*, *Journal of European Economic Association*, *Review of Economics and Statistics*, *Journal of International Economics*, and *Journal of Development Economics*. Her work has also appeared in many invited book volumes, policy outlets, and featured in World Bank Reports and International Monetary Fund, World Economic Outlooks. She is the first Turkish social scientist to receive the Marie Curie IRG prize in 2008 for her research on European Financial Integration. Her current research focuses on measuring the globalisation of European firms and investigating the linkages between real and financial sectors in a globalised economy together with the effects of such linkages on economic fluctuations and development.

Stefano Micossi is Director General of ASSONIME (Association of the Italian joint stock companies) and Visiting Professor in the Department of European Economic Studies at the College of Europe in Bruges. He is also Chairman of the Scientific Council of the LUISS School of European Political Economy (SEP) and member of the Board of Directors of CEPS (Centre for European Policy Studies), Cassa Depositi e Prestiti, BNL – BNP Paribas and CIR Group. He is also the founding member and coordinator of EuropEos, an association of leading journalists, jurists, economists and political scientists created in 2003 to foster the construction of Europe. He is a former Director General for Industry at the European Commission (1994-1998). He has published extensively in national and international economic journals on macro-economics, international economics and European economic and policy affairs. He has written influential Policy Briefs for CEPS and VoxEU, editorial comments for *Il Sole 24 Ore*, *La Stampa*, the *Financial Times*, the *Wall Street Journal Europe*, La Voce, Project Syndicate, and at present collaborates regularly with La Repubblica – Affari e Finanza. He is the author of three widely read pamphlets on the financial crisis, "Keep it simple: Policy responses to the financial crisis" (with Carmine Di Noia, Assonime and CEPS, March 2009); "Overcoming too big to fail – A regulatory framework to limit moral hazard and free riding in the financial sector" (with Jacopo Carmassi and Elisabetta Luchetti, Assonime and CEPS, March 2010), and "Time to set banking regulation right" (with Jacopo Carmassi), CEPS, March 2012.

Tommaso Monacelli is Professor of Economics at Università Bocconi, Milan. He holds a Ph.D. from New York University (1999), has been Assistant Professor at Boston College (1999-2002) and at Igier-Bocconi (2002-2005). He is Research Affiliate of CEPR and Associate Editor of the *Journal of Money Credit and Banking*. He has been research consultant for the ECB, Visiting Scholar at IMF, ECB and Riksbank, and Visiting Professor at CEU. He has published in various refereed journals in the area of open economy macroeconomics and monetary economics.

Elias Papaioannou is Associate Professor of Economics at London Business School. He is a research affiliate of CEPR and the NBER. He holds an LL.B. from the law school of the National and Kappodistrian University of Athens, Greece, a Masters in Public Policy and Administration (MPA) with a concentration in international economics from Columbia University, and a Ph.D. in economics from London Business School. After the completion of his doctorate in 2005 he worked for two years at the Financial Research Division of the European Central Bank (ECB) in Frankfurt, Germany. From 2007 till 2012 he served as Assistant Professor of Economics at Dartmouth College (NH, USA), while during the 2010-2011 and 2011-2012 academic years he was a Visiting Assistant Professor at the Economics Department of Harvard University (MA, USA). His research interests cover the areas of international finance, political economy, applied econometrics, macro aspects of regulation, law and finance, and growth and development. He has published in many leading peer-refereed journals, such as the *Journal of Finance*, *Econometrica*, the *Economic Journal*, the *Review of Economics and Statistics*, the *Journal of Development Economics*, the *Journal of the European Economic Association*, the *Journal of International Economics*, and more. His work has also appeared in numerous edited book volumes. His research has been recognised with the 2005 Young Economist Award from the European Economic Association and the 2008 Austin Robinson memorial prize from the Royal Economic Association. Elias consultants regularly international organisations, major investment banks, hedge funds, and institutional investors on macroeconomic developments in the EU and Greece.

Paolo Pesenti is a Vice President and Monetary Policy Advisor at the Federal Reserve Bank of New York. Previously, he taught at Princeton, New York, and Columbia Universities and served as a consultant to the ECB and a resident scholar at the IMF. Dr. Pesenti is affiliated with CEPR and NBER. His widely published and award-winning research specialises in international macroeconomics and finance. He has served on the editorial boards of the *Journal of International Economics*, the *Journal of Money, Credit, and Banking*, and the *Economic Policy Review*. He holds a Ph.D. in Economics from Yale University.

Jean Pisani-Ferry is a Professor at the Hertie School of Governance in Berlin, and currently serves as the French government's Commissioner-General for Policy Planning. He is a former director of Bruegel, the Brussels-based economic think tank. He was previously Director of CEPII, the main French research institute in international economics (1992 - 97), and Executive President of the French Prime Minister's Council of Economic Analysis (2001 - 02). His policy experience includes positions with the European Commission (1989 - 92) and working as the economic advisor to the French Minister of Finance (1997-2000).

Christopher Pissarides is the Regius Professor of Economics at the London School of Economics and Political Science. He specialises in the economics of unemployment, labour-market theory, labour-market policy and more recently he has written about growth and structural change. He has written extensively in professional journals and his book *Equilibrium Unemployment Theory* (MIT Press) is a standard reference in the economics of unemployment. He has served as Head of the Economics Department at the LSE, and he is an elected Fellow of the British Academy, the Econometric Society, the European Economic Association and the Society of Labor Economists. He has served on the European Employment Task Force (2003) and he has been a consultant on employment policy and other labour issues for the World Bank, the European Commission, the Bank of England and the OECD. He was awarded the 2010 Nobel Prize in Economics, jointly with Dale Mortensen of Northwestern University and Peter Diamond of MIT, for his work in the economics of markets with frictions.

André Sapir holds a PhD in Economics from The Johns Hopkins University (1977). He is professor at ULB, where he holds a chair in international economics and European integration. He is also a Senior Fellow of the Brussels European and Global Economic Laboratory (BRUEGEL) and a Research Fellow of the Centre for Economic Policy Research. He was previously a member of European Commission President Jose Manuel Barroso's Economic Policy Analysis Group.He was an Economic Advisor to European Commission President Romano Prodi (2001-2004) and the Chairman of the High-Level Study Group appointed by him that produced the 2003 report "An Agenda for a Growing Europe", widely known as the "Sapir Report", published by Oxford University Press in March 2004. He is a founding Editorial Board Member of the *World Trade Review*, published by Cambridge University Press and the World Trade Organisation.

Christoph M. Schmidt studied economics at the University of Mannheim, Germany, where he received his degree as Diplom-Volkswirt in 1987, at Princeton University, where he received his M.A. in 1989 and his Ph.D. in 1991, and at the University of Munich, where he received the degree of Dr. rer. pol. habil. in 1995. Since 2002 he has been President of the Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen and Professor at Ruhr-Universität Bochum. He has been a member of the German

Council of Economic Experts since 2009. In 2011 he was appointed as a member of the Enquete-Commission "Wachstum, Wohlstand, Lebensqualität" ("Growth, Welfare, Quality of Live") of the German Bundestag, since June 2011 he is member of acatech – Deutsche Akademie der Technikwissenschaften. From 1995 to 2002 he taught econometrics and labor economics as a Full Professor at the University of Heidelberg. he is a CEPR Research Fellow and a Research Fellow at the Institute for the Study of Labor (IZA), Bonn. He serves as an Editor of the *German Economic Review* and was an editor of the *Journal of Population Economics*. He published articles in journals such as *The Review of Economics and Statistics* and the *Journal of Public Economics*.

Isabel Schnabel is Professor of Financial Economics at Johannes Gutenberg University Mainz and Member of the German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung), an independent advisory body of the German government. Since 2009, she has been Deputy Dean of the Graduate School of Economics, Finance, and Management (GSEFM). She is Research Fellow at the Centre for Economic Policy Research (CEPR) and a CESifo Research Fellow, and Research Affiliate at the Max Planck Institute for Research on Collective Goods in Bonn. Isabel Schnabel received her doctorate from the University of Mannheim and served as Senior Research Fellow at the Max Planck Institute for Research on Collective Goods in Bonn. She has been a visiting scholar at the International Monetary Fund (IMF), the London School of Economics, and Harvard University. She is currently member of the Administrative and Advisory Councils of the German Federal Financial Supervisory Authority (BaFin) and of the Advisory Scientific Committee (ASC) of the European Systemic Risk Board (ESRB). Her research focuses on financial stability, banking regulation, and international capital flows.

Guido Tabellini has been Professor of Economics at Bocconi University in Milan since 1994, where he has been Rector since November of 2008. Previously, he taught at Stanford University and UCLA. He is a foreign honorary member of the American Academy of Arts and Sciences, a fellow of the Econometric Society, and a joint recipient of the Yrjo Jahnsson award from the European Economic Association. He is a CEPR Research Fellow. He has been President of the European Economic Association. He has acted as an economic consultant to the Italian government, the European Parliament and the Fiscal Affairs Department of the International Monetary Fund. The main focus of his research is on how political and policymaking institutions influence policy formation and economic performance. Much of his recent research is summarised in two books co-authored with Torsten Persson - *Political Economics: Explaining Economic Policy*, MIT Press, 2000; and *The Economic Effects of Constitutions*, MIT Press, 2003. He earned his PhD in Economics from UCLA in 1984.

Volker Wieland is Managing Director of the Institute for Monetary and Financial Stability (IMFS) at Goethe University Frankfurt where he also holds the Endowed Chair of Monetary Economics. From 2000 to 2012 he was Professor of Monetary Theory and Policy at Goethe University. He is member of the German Council of Economic Experts and the Scientific Advisory Council of the Federal Ministry of Finance and also belongs to the Kronberger Kreis that is the Scientific Council of the Market Economy Foundation. He is a CEPR Research Fellow. In 1995, he received a Ph.D. in Economics from Stanford University. Before joining Goethe University, he was a senior economist at the Board of Governors of the Federal Reserve System in Washington, DC. In 2008 he was awarded the Willem Duisenberg Research Fellowship by the European Central Bank. His research interests include monetary and fiscal policy, business cycles and macroeconomic models, learning and economic dynamics as well as numerical methods in macroeconomics. His work has been published in leading economic journals such as the *American Economic Review*, the *Journal of Monetary Economics*, the *Journal of the European Economic Association*, the *European Economic Review* and the *Journal of Economic Dynamics and Control*. Professor Wieland has also served as Managing Editor of the *Journal of Economic Dynamics and Control* and remains a member of the JEDC Advisory Board.

Charles Wyplosz is Professor of International Economics at the Graduate Institute, Geneva, where he is Director of the International Centre for Money and Banking Studies. Previously, he has served as Associate Dean for Research and Development at INSEAD and Director of the PhD program in Economics at the Ecole des Hautes Etudes en Science Sociales in Paris. He is a CEPR Research Fellow and has served as Director of the International Macroeconomics Programme at CEPR. He is CEPR's Policy Director.

Foreword

In September 2015 CEPR published an eBook with the goal of establishing a consensus on the causes of and a narrative for the Eurozone crisis. This was to be a first step towards developing a consensus on what should be done to fix the Eurozone's current problems and to create mechanisms that will make the next crisis less damaging. *The Eurozone Crisis: A Consensus View of the Causes and a Few Possible Solutions* included some concrete ideas as to the best way forward, but the issue of fixing the Eurozone was left as a task to be tackled in future eBooks.

This new eBook collects essays from a broad range of leading economists on what more needs to be done to fix the Eurozone. Although the authors disagree on solutions, there is a broad consensus on the list of necessary fixes, which include completing the Banking Union; breaking the 'doom loop' between banks and their sovereigns; ensuring that the risk of mega-shocks is shared across the EZ; coordinating EZ-level fiscal policy while tightening fiscal discipline at a national level; cleaning up the legacy debt problem; and continuing to implement structural reforms that enable the monetary union to function more effectively.

Each chapter presents solutions to one or more of these challenges. Taken together, they are the most complete catalogue of solutions to date – representing views that range from calls for sharp increases in European integration to those that favour national, market-based solutions.

This is the second step in a bigger CEPR project, "Rebooting Europe", which seeks to marshal a critical mass of Europe's best thinkers in developing ways to get Europe working again and to undertake a systematic rethink of today's European socio-economic political system. In short, to figure out a way to update Europe's 'operating system' and reboot.

Our thanks go to Charlie Anderson for excellent and efficient handling of the eBook's production within a very tight timescale. CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this topic which is critical to the future of the EU.

Tessa Ogden
Deputy Director, CEPR
February 2016

Introduction

Richard Baldwin and Francesco Giavazzi
The Gradute Institute and CEPR; Bocconi University and CEPR

The first eBook in the Rebooting Europe project collected essays from a wide range of leading economists on a simple question: "What caused the EZ Crisis?" (Baldwin and Giavazzi 2015, Figure 1, left panel). This second eBook in the Rebooting Europe project collects essays on an equally simple question: "What more needs to be done to fix the Eurozone?"

To provide a common base for the authors of this second eBook, we followed up the first eBook with a process that developed a consensus narrative on what caused the EZ Crisis. The idea was that it would be easier to find agreement on how the monetary union should be fixed, if we first found agreement on how and why things went wrong during the EZ Crisis.

The result of this consensus process was an essay that expressed a 'consensus' view on the causes of the EZ Crisis (published in November 2015, Figure 1, right panel). Although not all the authors of the first eBook were willing to put their name to it, the document "Rebooting Europe: Step 1 – agreeing a crisis narrative" was ultimately signed by 16 leading economists hailing from a broad range of views (Figure 1, right panel). It has garnered support from more than 90 other eminent economists and been viewed almost 50,000 times on VoxEU.org (Figure 1, left panel).

Figure 1 The Consensus on causes of the EZ Crisis: eBook and negotiated consensus

Rebooting the Eurozone: Step 1 – agreeing a crisis narrative

Richard Baldwin, Thorsten Beck, Agnès Bénassy-Quéré, Olivier Blanchard, Giancarlo Corsetti, Paul de Grauwe, Wouter den Haan, Francesco Giavazzi, Daniel Gros, Sebnem Kalemli-Ozcan, Stefano Micossi, Elias Papaioannou, Paolo Pesenti, Christopher Pissarides, Guido Tabellini and Beatrice Weder di Mauro

Introduction and summary

The Eurozone crisis broke out in May 2010 and it is a long way from finished. Although some positive signs have emerged recently, EZ growth and unemployment are miserable and expected to remain miserable for years.

- A large slice of Europe's youth have been or will be jobless during the critical, formative years of their working lives.
- The economic malaise is feeding extremist views and nationalistic tendencies just when Europe needs to pull together to deal with challenges ranging from the migration crush to possible new financial shocks.

Worse yet, many of the fragilities and imbalances that primed the monetary union for this crisis are still present. Many of Europe's banks face problems of non-performing loans. Many are still heavily invested in their own nation's public debt – a tie that means problems with banks threaten the solvency of the government and vice versa. Borrowers across the Continent are vulnerable to the inevitable normalisation of interest rates that have been near-zero for years.

As a first step to finding a broad consensus on what needs to be done to fix the Eurozone, this essay presents what we believe is a consensus answer to the question:

- "What caused the Eurozone Crisis?"

Although the authors hark from diverse backgrounds, we found it surprisingly easy to agree upon a narrative and a list of the main causes of the EZ Crisis. We say "surprisingly" since EZ policymakers remain attached to very diverse narratives of the Eurozone Crisis.

The need for a consensus narrative

Formulating a consensus on the causes of the EZ Crisis is essential. When terrible things happen, the natural tendency is to fix the immediate damage and take steps to avoid similar problems in the future. It is impossible to agree upon the steps to be taken without agreement on what went wrong. Absent such agreement, half-measures and messy compromises are the typical outcome. But this will not be good enough to put the EZ Crisis behind us and restore growth.

This is why formulating a consensus narrative of the EZ Crisis matters so much. Eurozone decision-makers will never agree upon the changes needed to prevent future crises unless they agree upon the basic facts that explain how the Crisis got so bad and lasted so long.

The causes of the EZ Crisis

The core reality behind virtually every crisis is the rapid unwinding of economic imbalances. In the case of the EZ Crisis, the imbalances were extremely unoriginal – too much public and private debt borrowed from abroad. From the euro's launch till the Crisis, there were big capital flows from EZ core nations like Germany, France, and the Netherland to EZ periphery nations like Ireland, Portugal, Spain and Greece.

A major share of these capital inflows were invested in non-traded sectors – housing and public consumption. This meant assets were not being created to pay off the borrowing – and thus rebalance the balance of payments. Foreign-financed domestic spending tended to drive up wages and costs in a way that harmed the competitiveness of the receivers' export earnings and encouraged further worsening of their current accounts.

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The consensus narrative in brief

To briefly summarise, the proximate cause of the Eurozone crisis was a 'sudden stop', namely the rapid unwinding of intra-Eurozone lending/borrowing imbalances that built up in the 2000s. But this was not the underlying cause. Two design failures were responsible for the crisis:

- The absence of a control mechanisms which could have stopped the build-up of large intra-EZ current account imbalances, large public debt levels, and excessive bank leverage.

These large debt and flow imbalances made the Eurozone fragile and vulnerable to self-fulfilling cycles that could turn modest shocks into an historic crisis.

- The absence of institutions that could have allowed the Eurozone to deal with the sudden stop and thus avoid the train of events that produced Europe's worst economic crisis since WWII.

By design, the Eurozone – differently from the US – had no buyer-of-last-resort for bad private or government debt. As a consequence, re-funding difficulties in banks or nations could – and did – trigger self-fulfilling liquidity crises that degenerated into solvency problems. This is how a sudden-stop crisis morphed into a public debt and banking crisis.

Lessons learned and progress to date on fixing the Eurozone

At the outset, we must acknowledge that there is nothing novel about the notion that the Eurozone needs completing. Most of our authors have published on this topic since the EZ Crisis struck (see their individual chapters for references). The basic shortcomings have been known and discussed by economists since the euro was launched. This may be seen as reassuring in the sense that the realisation that the Eurozone has shortcomings does not depend on elaborate new theories, empirical findings or controversial interpretations of the EZ Crisis. Based on nothing more than simple economic logic and basic economic facts, many flaws were obvious from the start.

For example, a CEPR report wrote: "The ECB suffers serious faults in its design that sooner or later will surface. This is likely to happen when large shocks [Editors' note: the Report refers to the 1997 Asian Crisis], hit euroland. … The lack of centralised banking supervision, together with the absence of clear responsibilities in crisis management, risk making the financial system in euroland fragile. No secure mechanism exists for creating liquidity in a crisis, and there remain flaws in proposals for dealing with insolvency during a large banking collapse." (Begg et al 1998).

These problems were swept under the rug during the halcyon days of the Eurozone's first decade.

The problems remain

As one of our authors, Nobel Prize winner Chris Pissarides writes: "There are certain conditions needed to make a common currency across diverse economies a success and the Eurozone is clearly not satisfying them." Agnès Bénassy-Quéré extends the thought in saying, "The Eurozone was conceived as a monetary union without a sovereign. It was just an arrangement between several member states to share monetary sovereignty, provided they commit not to abuse the system through fiscal profligacy. This arrangement failed."

The same has been recognised by the so-called 'Five Presidents' Report'. "Europe's Economic and Monetary Union (EMU) today is like a house that was built over decades but only partially finished. … we will need to take further steps to complete EMU." (European Commission 2015). It proposes the completion, in the long run, of three unions to match the Monetary Union: Economic Union (including Banking Union and Capital Market Union), Fiscal Union, and Political Union.

While the Five Presidents' report was an important step in getting the debate going, it seems to be unrealistically ambitious in the long run – essentially pushing all the way to something like a United States of Europe. At the same time, it is insufficiently ambitious in the short run – shying away from reforms that would require a Treaty change.

Our authors almost all start from the perspective that fixing the Eurozone will require changes in the Treaty. Half-measures and muddling through will not do the job. They take a fresh look at the problems and potential solutions using clear economic reasoning and the best available evidence. Most authors question some or all of the ideas in the Five President' Report.

Progress to date and solutions still needed

Since the crisis began in 2010, a number of changes have made the Eurozone more resilient. Especially important are four sets of reforms. We discuss these in turn.

- A partial Banking Union.

While still incomplete, the Banking Union takes a big step towards reducing systemic risk in the Eurozone. Before the Crisis, banks were a national responsibility. Yet during the Crisis, it became clear that responsibility for stabilising the EZ banking system was a burden that could only be shouldered at the EZ level.

Indeed, one reason the Crisis was so costly was the so-called 'doom loop' connecting governments and their banks. This acted as a crisis amplifier whereby weak governments increased the cost of financing for banks and in turn the difficulties of banks then depressed the economy, which then weakened both governments and banks even further.

EZ leaders recognised this problem when they decided in the summer of 2013 to centralise banking supervision (delegating it to the ECB) and to create a common institution to restructure banks in difficulties. This combination, which has been dubbed the 'Banking Union', is a work in progress. The Italian banking crisis which erupted at the beginning of the year is a testimony of how imperfect the Banking Union remains when it comes to resolving banks. Also, the problems posed by the overly close links between sovereigns and their banks still remain.

As Daniel Gros points out in his chapter, "in many EZ members, banks hold debt of their own sovereign equivalent to more than 200% of their capital." Rises in the risk premia of the sovereign's debt during a crisis always lowers the market value of government bonds on the banks' balance sheets. A substantial rise in the risk premium can thus wipe out a bank's capital.

Virtually all of our authors agree that completing the Banking Union is one of the essential fixes that the Eurozone must undertake.

- The European Stability Mechanism (ESM).

The ESM is designed to help share risk among EZ members by providing financial assistance to crisis-stricken countries in the Eurozone.

All agree that the ESM is a very important step forward. Many authors, however, point to its shortcomings. Guido Tabellini, for example writes: "it is doubtful whether its current structure is adequate to prevent the risk of sudden stops. Its resources … may be insufficient to deal with large systemic crisis, [and] the decision to provide stability support to an ESM member is taken by unanimity and requires prior approval by some national Parliaments. This makes the question of whether and how the ESM resources would actually be available far too uncertain and open-ended to instil confidence."

The key difficulty here is, as Thorsten Beck notes, is the balancing of market discipline and certainty. "A long-term sustainable monetary union has to combine a minimum degree of market discipline with a minimum degree of certainty…".

- The Outright Monetary Transactions (OMT) programme.

During the EZ Crisis, several EZ members whose debt was viewed as sustainable in 2010 slipped towards a self-feeding debt vortex whereby rising interest premiums made current debt to GDP ratios look questionable and the resulting questioning lowered credit ratings and forced market rates higher. It is basically impossible for an individual member to face this sort of dynamic alone. Once the vortex reaches a critical speed, it can only be stopped by an outside intervention. Before the Crisis, the Eurozone lacked any mechanism for rescuing members stricken by this sort of attack.

With the creation of the OMT programme, the ECB provided itself with a powerful tool for ending such self-fulfilling debt vortexes. The OMT allows the ECB to intervene on secondary debt markets (in the presence of adequate conditionality). Although still untested, the very existence of Outright Monetary Transactions has been a major stabilisation tool.

OMT is applauded by many of our authors, but most view it as a stop gap measure that needs to be complemented with more direct measures that reduce the likelihood and cost of any future cycles where an EZ member's liquidity problem get transformed into a solvency problem. Eichengreen and Wyplosz for example write: The ECB must be able to "… backstop financial markets, thereby protecting the Eurozone from potentially self-fulfilling crises. These are functions, in a monetary union that must be provided at a centralised level if they are provided at all."

So far, OMT exists in theory but has never been put into practice. One set of authors, four members of the influential German Council of Economic Experts – Lars Feld, Christoph Schmidt, Isabel Schnabel and Volker Wieland – write that OMT threatens "… to blur the line between monetary and fiscal policy." As such, "this is hardly a sustainable situation" they opine. Their proposal involves making sure that authority and accountability reside either at the national level, or at the EZ level. They view OMT as uncomfortably straddling the two. It does not satisfy their guiding principle that "in each relevant policy field control over fiscal and economic policy action is accompanied by liability for the consequences of such action."

Peter Bofinger, by contrast, views OMT as not going far enough: "A main challenge is the specific insolvency risk to which the member states are exposed. … With the OMT programme the ECB has provided a pragmatic and so far effective protection against this risk. But in the longer-term it can only be eliminated by some form of debt mutualisation. "

- Tighter controls over EZ members' fiscal policy.

The Maastricht Treaty foresaw common surveillance and discipline over members' debts and deficits. These were fleshed out early on in the Stability and Growth Pact (SGP). Over the course of the EZ Crisis, the Pact was substantially stiffened with rather massive amounts of national sovereignty being shifted to European control. There were five new provisions and one directive (the "Six Pack"), and surveillance and coordination were enhanced (the "Two Pack"). Fiscal rules were anchored at the national level via the Fiscal Compact.

While useful, most authors feel the system has become unworkable. As Jean Pisani-Ferry writes: "The piling up of fiscal, economic, and financial surveillance procedures has made the system of policy rules undecipherable even for insiders. For this reason there is little ownership of it among national policymakers, and even less among national parliamentarians… The perceived legitimacy of the policy system is low and the credibility of eventual sanctions remains questionable. There is a growing risk that a government will call the bluff and openly defy the Eurozone's fiscal rules."

Not yet a normal monetary union

These advances represent significant progress towards more sharing of both sovereignty and risk. They all work in the direction of normalising the Eurozone with respect to existing federations where banking supervision is a federal responsibility; sub-national debt crises are generally solved (except for very small entities) through some form of conditional financial assistance from the federal level and the central bank may purchase securities issued or guaranteed by the federal government, in sharp contrast with the predominance of national debts in the Eurozone. But they remain a far cry from making the Eurozone a 'normal' federation.

One particularly pernicious problem is that "The European monetary union lacks a mechanism that can deal with divergent economic developments (asymmetric shocks) between countries," as Paul De Grauwe and Yuemei Ji point out in their contribution. André Sapir goes on to point out that: "the Eurozone lacks the degree of risk sharing seen in other jurisdictions with respect to three dimensions, " namely smoothing at the federal level of economic shocks on the sub-federal level, fiscal insurance (backstopping) for public debt, and risk sharing via private channels such as capital markets and banks.

What more is needed to fix the Eurozone

The eBook has 18 chapters, many of which present a number of reform proposals. We cannot possibly do justice to all of these in our introduction. What we can say is that the chapters are surely the most comprehensive collection of solutions that has ever been assembled. These chapters will give the reader a full mastery of virtually all the problems and all the serious solutions that have been proposed (including a number of proposals that have not appeared elsewhere).

What is easy to summarise is our authors' views on what needs fixing. Although they disagree on solutions, there is a broad consensus on the list of needed fixes. These include:

- Completing the Banking Union;
- Breaking the 'doom loop' between banks and their sovereigns;
- Ensuring EZ-wide risk sharing for Europe-wide shocks;
- Cleaning up the legacy debt problem;
- Coordinating EZ-level fiscal policy while tightening national-level discipline;
- Advancing structural reforms for a better functioning monetary union.

Each chapter presents solutions to one or more of these challenges and several of the chapters view solutions to one problem as inexorably linked with the solution to one or more of the other problems. It is our hope that this collection advances the process of developing solutions that can fix the Eurozone.

Concluding remarks

After the turmoil and high drama that rocked the Eurozone from 2010 to 2015, we have entered a period of quiescence. When it comes to risk-spreads on EZ government bonds, it is easy to think that the worst of the Crisis is behind us. This is a mistake. The turbulence that hit financial markets in the first few weeks of 2016 was enough to produce a widening of interest rate spreads in the countries with weaker fundamentals. This may be the eye of the storm, not the end of the storm.

The Eurozone remains a damaged vessel that has been made seaworthy with makeshift solutions and half-measures. The ECB’s resolve and the area’s gradually improving macroeconomic performance is keeping the euro afloat for now. But this is accomplished by something akin to bailing the water as fast as it leaks in. European leaders must very soon find permanent and coherent solutions to the Eurozone’s shortcomings.

It is time to cast aside national and ideological differences and complete the job of restoring stability and prosperity in Europe. The time to start is now.

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Part 1

Complete reform plans

Minimal conditions for the survival of the euro

Barry Eichengreen and Charles Wyplosz
University of California Berkeley and CEPR; The Graduate Institute and CEPR

The Eurozone crisis has shown that monetary union entails more than just sharing monetary policies. This column identifies four minimal conditions for solidifying the monetary union. In the case of fiscal policy, this means a decentralised solution. In the case of financial supervision and monetary policy, centralisation is unambiguously the appropriate response. In the case of a fourth condition, debt restructuring, either approach is possible, but the authors prefer a solution that involves centrally restructuring debts while allocating costs at national level.

In this column we set out minimal conditions for the survival of the euro. Typically this issue is framed as whether European monetary integration, which reached its apogee with the euro, will now be complemented by the political integration needed for the single currency to survive. This is how the technocrats and political intelligentsia responsible for the euro's creation saw things; since monetary union is not possible without political union, creating the euro was a way of forcing the pace of political integration.

Limits to political integration

This is not how we see things. Over the timeframe relevant for the euro's survival, political integration in Europe has its limits. This is what historical comparisons suggest. It took the US more than a century including the experience of a devastating civil war before it became a true, irrevocable political union, and Europe is only a short way down that path. The euro's existential crisis is likely to be resolved one way or the other long before that political destination is reached.

Economic theory similarly suggests limits to European political integration. Public finance theory (e.g. Buchanan 1965) points to the existence of economies of scale in the provision of public goods (integration allows public goods like fiscal coinsurance and a well-regulated banking system to be provided more cheaply), underscoring the advantages of political integration and centralisation. But it also highlights the costs of centralised provision since populations are heterogeneous and preferences for public goods differ across groups and regions – costs that create understandable resistance to pooling responsibility for provision.

This tension is evident in how Europe has responded to its crisis. In some areas where evidence of increasing returns is overwhelming, Europe has moved toward centralised provision. Examples include centralised provision of backstop facilities for sovereign debt markets (the European Central Bank's Outright Monetary Transactions) and creation of the Single Supervisor (with responsibility for oversight of the banking system).

But in other areas the benefits of centralised provision are dominated by the costs of uniformity, creating resistance to further centralisation. This is true most obviously of fiscal policy where different countries have different tastes (insofar as countries as distinct from individuals have tastes) for fiscal rectitude and stabilisation, and different degrees of tolerance of debt and deficits. This heterogeneity in turn creates a problem of trust, i.e. can those formulating and executing the common policy be trusted to do so in a manner consistent with a group's tastes. This is analogous to the problem that results in an undersupply of public goods like policing and schools in localities where the population is heterogeneous, wherein each group is reluctant to pay additional taxes for fear that the resources so mobilised will go to pay for public goods valued by other groups but not by itself (Alesina et al. 1999).

In what follows we use these insights from theory and history to guide our discussion of minimal conditions for survival of the euro. The implication is that for the single currency to survive, Europe needs both more political integration and less political integration. The trick is to understand when less is more.

First condition

The first of our four minimal conditions for the survival of the euro is a normal central bank able to pursue flexible inflation targeting and backstop financial markets, thereby protecting the Eurozone from potentially self-fulfilling crises. These are functions, in a monetary union that must be provided at a centralised level if they are provided at all. Given the existence of a single monetary policy, there is little scope for governments to influence domestic inflation rates. National central banks (which partner with the ECB in the European System of Central Banks) can advance credit to domestic banks requiring liquidity only against eligible collateral and with the approval of the ECB to provide emergency liquidity assistance (ELA). Sovereigns, not having recourse to a national central bank, have limited ability to backstop their financial markets unilaterally.

As conceived initially, the ECB did not provide these functions. The bank's two-pillar strategy focused not just on inflation but also on growth of a talismanic monetary aggregate that bore no stable relationship to inflationary outcomes. Rather than adopting a symmetric inflation target, it pursued a target of less than but close to 2%, dangerously skirting deflationary territory. Under the presidency of Jean-Claude Trichet, it concentrated on headline rather than core inflation, leading it to raise interest rates in 2008 and 2011 when deflation was the fundamental underlying danger. It threatened to terminate the emergency liquidity assistance for Ireland in 2010 unless its government applied for a bailout and agreed to a programme of austerity and bank recapitalisation (ECB 2014). It stopped liquidity assistance for Greece in 2015 until the government agreed to a programme rejected by voters in a referendum.

It hesitated to adopt unconventional monetary policies when interest rates fell to the zero lower bound. It was reluctant to intervene with purchases of government bonds when investors doubted the 'essential cohesion' (Draghi 2014) of the Eurozone, fearing that the German Constitutional Court would rule such action incompatible with that country's Basic Law.

Hearteningly, the ECB has now moved some distance in the direction of becoming a normal central bank. Quantitative easing in March 2015 demonstrated that the members of its Governing Council understood the special and especially dangerous nature of deflation. In its day-to-day operations, the ECB effectively shelved the monetary pillar and now more carefully and systematically distinguishes core from headline inflation. While a symmetric inflation target and a smaller, nimbler monetary policy committee are still required, these are steps in the requisite direction.

What is now required to cement this progress?

- First, the ECB needs to heighten its transparency to correspond with its greater discretion and the breadth of powers invested in a normal central bank.

Transparency is a mechanism for holding an independent central bank accountable in the court of public opinion. It is a way of communicating to constituents that policies are being implemented with the common good and not particular national interests in mind. If the presence of national representatives on the Governing Council is an obstacle to taking and publishing formal votes, then this is an argument for reorganising the Council to reduce and eliminate the presence of those national representatives. Doing so would be a very limited step in the direction of greater political integration but a necessary one for survival of the euro.

- Second, the ECB, when undertaking purchases of government bonds in the context of quantitative easing or conventional open market operations, needs assurance that its decisions will not be disallowed by the German Constitutional Court.

This may require a change in Germany's basic law or an unambiguous statement by its Constitutional Court that it will accept the judgment of the European Court of Justice on ECB-related matters. Changing this aspect of the basic law to conform to EU jurisprudence would be a limited step in the direction of political integration.

Second condition

A second minimal condition for the survival of the euro is completing Europe's banking union. The crisis has underscored how banking-system stability is a Eurozone-wide public good subject to strongly increasing returns. One need only recall how lax regulation of French and German banks allowing these institutions to lend hand over fist to southern European countries helped to set the stage for the crisis, or how the subsequent problems of some banks then threatened to destabilise others via the interbank market and related mechanisms. For good and bad reasons, member states harbour somewhat different tastes about precisely how they prefer to supervise and resolve their banks. But experience has shown that this is an area where strongly increasing returns from centralised provision dominate costs of uniformity. As the point is sometimes put, monetary union without banking union will not work.

To this end, Eurozone member states (and other EU member states that choose to opt in) have created a Single Supervisor of financial institutions, locating the Supervisory Board in the ECB. The Single Supervisory Mechanism oversees large financial institutions and works closely with national supervisors overseeing other intermediaries. The Single Supervisor has already intervened to enhance the public good of financial stability, for example, by limiting the exposure of Greek banks to the Greek government and more generally by pressing the banks it supervises to reduce home bias in their sovereign bond portfolios (Veron 2015).

In addition, the European Parliament and Council have adopted a common mechanism for resolving failed financial institutions, the Bank Recovery and Resolution Directive. This obliges all EU governments to bail in unsecured creditors before tapping taxpayer funds, requiring members to implement these rules through national legislation. Again, these are limited but necessary steps in the direction of financial and political centralisation.

The 'political bridge too far' has been the creation of a common bank deposit guarantee fund in which money from all Eurozone members will be pooled to guarantee that bank accounts up to €100,000 are fully insured. Under the terms of the banking union, member states are now required to establish conforming insurance schemes for accounts up to this ceiling, the crisis having shown that non-uniformity and, in some cases, the absence of deposit insurance can threaten confidence and financial stability monetary-union wide. But deposit insurance is only confidence inspiring if the funds standing behind it are adequate to meet potential claims, and the members of a monetary union, not being able to resort to central-bank finance, may find it difficult to come up with the necessary funds in extremis. This is why deposits in the US, following experience with state bank holidays in the 1930s, are federally rather than state insured.

Some countries, notably Germany, worry that other members will be more prone to draw on the fund (German commentators regularly cite Greece as a case in point). They reject mutualisation of deposit insurance as a de facto fiscal transfer. The response comes in three parts. First, banking stability is a valuable public good subject to sufficiently increasing returns that centralisation of the deposit-insurance function is warranted. Second, all member states, not least Greece, are required to implement the banking union's new resolution rules to limit taxpayer liability. Third, this is a limited and specific mutualisation of fiscal powers targeted at a specific financial problem intimately associated with monetary union, not the wholesale centralisation of fiscal control at the level of the EU or the Eurozone.

Third condition

This of course begs the question of whether the wholesale centralisation of fiscal functions is desirable – whether, as the point is sometimes put, monetary union without fiscal union will not work. Since the Maastricht Treaty and the Stability and Growth Pact, there have been repeated efforts to centralise EU fiscal policies. These early attempts have now been supplemented by further initiatives by the European Commission, including the Six Pack, the Two Pack, the European Semester, and a new treaty (the Treaty on Stability, Coordination and Governance in Europe).

The one thing these measures have in common is that they do not work. EU member states have profoundly different preferences with regard to fiscal policy. They are reluctant to mutualise fiscal resources or delegate decisions over national fiscal policies to the Commission and the European Parliament, since the consequent decisions would differ markedly from the preferences of some members. How taxes are raised and public spending is structured are intimately bound up with the details of nation's culture and history. Fiscal policy is fundamentally political and distributive, limiting delegation even at the national level. From the start, it was evident that EU members were reluctant to interfere in such matters (Eichengreen and Wyplosz 1998). It is unclear why the future should be different from the past.

To be sure, fiscal policy has some of the characteristics of a public good. Its macroeconomic effects spill across borders, and fiscal instability in one country can create instability in other countries insofar as one country's banks invest heavily in other countries' bonds and fiscal crises are met with multilateral bailouts. But the notion that there are strongly increasing returns from centralisation can be questioned. The magnitude of direct cross-border spillovers is limited; more deficit spending by Germany raises the demand for Italian exports but also drives up interest rates in Italy, partially offsetting the first effect. If cross-border spillovers result from the bank-sovereign doom loop, then the solution is to prevent banks from holding concentrated positions in sovereign bonds as the Single Supervisor is seeking to do. If the source is pressure for multilateral bailouts, then the solution is a no-bailout rule.

Is there an alternative to this doomed effort to centralise fiscal policy at the level of the Union? We would answer yes: it is to renationalise fiscal policy. This is our third minimal condition for the survival of the euro. The fiction that fiscal policy can be centralised should be abandoned, and the Eurozone should acknowledge that, having forsaken national monetary policies, national control of fiscal policy is all the more important for stabilisation. If reckless national fiscal policies endanger the banks, then the banks should be prohibited from holding sovereign bonds. There is no reason why a no-bailout rule of the sort enforced for US state governments since the mid-19th century would not then be credible. Absent expectations of a bailout, investors will pay better attention, and market discipline will be more intense. Governments in turn will have more incentive to strengthen their fiscal institutions and procedures so as to deliver better outcomes.

Fourth condition

Making effective use of fiscal policy for stabilisation presupposes removing inherited debt overhangs in whose presence fiscal policy is unavailable. Removing those overhangs is thus our fourth precondition for survival of the euro.

The question is whether this process is best organised at the national or EU level. Arguments can be made for both approaches. On the one hand, fiscal positions and thus preferences over restructuring differ across member states. Countries with unsustainable debts will prefer to see them restructured, whereas more lightly-indebted countries will fear losses and reputational consequences. Public choice theory points to the existence of costs of uniformity and centralisation in the presence of such heterogeneity.

On the other hand, the benefits of a centrally coordinated, encompassing approach are compelling when the survival of a public good, the euro itself, hinges on the outcome. A piecemeal approach in which a few countries regain fiscal flexibility but others do not is unlikely to permit to the repatriation of fiscal policy to the national level, violating another of our key conditions for the survival of the euro. Individual countries may be discouraged by the stigma attached to restructuring and by the associated poor credit ratings and risk premia, with the predictable result that no country will want to go it alone, or even to go first. An encompassing approach where debt overhangs are reduced across the Eurozone, allowing fiscal control to be delegated to the governments of all participating member states, will help to restore the macroeconomic and financial stability on which the euro's survival depends.

A centrally coordinated approach can also help to surmount two further obstacles to restructuring. First, it may be better able to overcome resistance from debtors. Banks in one Eurozone country will typically hold bonds issued by the government of another, and European institutions like the ECB hold national debts. If one country restructures its debts, it will impair the balance sheets of its own banks but also of banks in other countries. Isolated debt restructurings do not take this externality into account, whereas a collective approach can do so. It can distribute losses due to these externalities in many ways, including assigning them entirely to the country doing the restructuring. Whatever the solution chosen, the point is that under the collective approach there will be an agreement on burden sharing. If the agreed solution involves transfers – which is not necessarily the case, as shown below – then it will have to be agreed by officials of each country on behalf of its taxpayers rather than being imposed by a foreign authority.

The second obstacle is that debt restructuring may be seen as an encouragement to accumulate large debts in the future in the expectation that they will be restructured again. Weakening the bonding role of debt is therefore a source of moral hazard. Collective action may help to remove these objections. Member states will be aware of the risk and will demand incentives to require guarantees that countries will not act unilaterally and opportunistically in the future. The guarantees, which may take various forms (an example is provided below) may not be iron-clad, but they should be compared to how the issue is dealt with under the unilateral approach.

Several proposals have been advanced along these lines (see inter alia Buchheit et al. 2013, Corsetti et al. 2015 and Pâris and Wyplosz 2014). Pâris and Wyplosz (2014) for example propose replacing a significant part of all outstanding public debts with zero-coupon perpetuities. Under their proposal, the cost of the restructuring to European institutions like the ECB can be fully financed by seigniorage income. If debts are retired in proportion to shares of national governments in the capital of the ECB, then the benefit (debt write-down) for each country is exactly matched by the cost it incurs (the seignorage income it relinquishes). In this case there is no loss to debtholders and no transfer across countries. Enforcement is guaranteed by a commitment to convert the perpetuities back into debts in the event of non-compliance with the agreement. Since all countries participate, there is no stigma.

One can imagine other schemes for collectively restructuring the debt overhang of Eurozone members. But irrespective of the details, some scheme must be adopted to restructure public debts comprehensively enough for Eurozone member countries to recover the use of their national fiscal policies. The general point is that this kind of comprehensive restructuring is easier and less costly when carried out collectively. Once fiscal discipline and low national public debt are achieved, the no-bailout clause will have to be completed by a prohibition on ECB dealings in an individual country's debt instruments. If the ECB is able, even in theory, to purchase the debts of a government that gets into fiscal trouble, fiscal discipline enforced by the no-bailout rule will be incomplete. There is no need for such a prohibition in the US, since the Federal Reserve deals in federal government bonds, not the bonds of particular states. Creating the equivalent regime in the Eurozone would require limiting ECB bond-market transactions to the institution's own debt instruments, Eurobonds, and bonds purchased in proportion to the central bank's capital key. Thus, the new regime would permit quantitative easing (under which bonds are purchased according to the capital key) and open market operations structured analogously, but not Outright Monetary Transactions, under which the ECB purchases the bonds of an individual troubled economy, on that country's request.

Concluding remarks

The Eurozone crisis has shown that monetary union entails more than just sharing monetary policies, and that the common central bank must aim at more than just price stability. While completing the architecture is challenging, doing so does not require a forced march to political union. Club theory suggests that a political union is not justified at this stage.

That theory also sheds light on desirable ways of addressing the problems exposed by the crisis. We have identified four minimal conditions for solidifying the monetary union. In one case, fiscal policy, this means a decentralised solution. In the case of two other conditions, financial supervision and monetary policy, centralisation is unambiguously the appropriate response. In the case of a fourth condition, debt restructuring, either approach is possible, but we prefer a solution that involves centrally restructuring debts while allocating costs at national level.

These conditions, while necessary, are sufficient as well, or at least we hope. They should be enacted as quickly as possible.

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Maastricht 2.0: Safeguarding the future of the Eurozone

Lars P. Feld[*], Christoph M. Schmidt[†], Isabel Schnabel[‡] and Volker Wieland[§]

[*]Walter Eucken Institute and University of Freiburg

[†]RWI Essen, IZA and CEPR

[‡]Johannes Gutenberg University Mainz, German Council of Economic Experts and CEPR

[§]Goethe University Frankfurt and CEPR

Not everybody agrees that the Greek crisis means the EU needs more integration. This column, from the German Council of Economic Experts, argues that for as long as EZ members are unwilling to transfer national sovereignty over economic and financial policy to the European level, all reform proposals must withstand a critical evaluation of the incentives they set for national economic and financial policy. The institutional framework of the single currency area can only ensure stability if it follows the principle of that liability and control must go hand in hand. Those who decide must bear the consequences of their decisions.

Our piece in the first the VoxEU eBook on the Eurozone crisis (Baldwin and Giavazzi 2015) emphasised two fundamental weaknesses of the Eurozone prior to the crisis:

- Firstly, there was a lack of economic and fiscal policy discipline, accompanied by dysfunctional sanctioning mechanisms as well as flawed financial regulation, leading to the build-up of huge public and private debt levels and a loss of competitiveness;
- Secondly, there was no credible mechanism for crisis response regarding bank and sovereign debt problems that would have been able to reign in moral hazard problems and establish market discipline.

These institutional deficits amplified economic imbalances in the economically heterogeneous currency area and made the economies of some member states vulnerable to the global financial crisis. In its aftermath Greece, Ireland and Portugal experienced government debt crises, which ultimately threatened the cohesion of the entire Eurozone. In Spain, a government debt crisis was averted, as banks obtained European funds for recapitalisation.

Causes of the Eurozone crisis: A nuanced view

Thus, our assessment differs in subtle, albeit important aspects from the 'consensus view ' as briefly summarised in Baldwin et al (2015). Specifically, since flows of capital as well as goods and services are market outcomes, we would not implicate the "intra-Eurozone capital flows that emerged in the decade before the crisis" as the "real culprits". In a monetary union, substantial capital inflows from higher-income regions might very well support income growth in member states with low per-capita income. There is nothing pathological about that, as long as the classical forces of conditional convergence apply.

Problems arise, however, when increased public borrowing is used for consumption spending and not for capacity- and productivity-enhancing investment, as was the case in Greece; or when increased private borrowing is motivated by excessive risk-taking stimulated by an insufficiently regulated and supervised banking sector as in Spain and Ireland.

- Hence, in our view, it is the government failures and the failures in regulation and supervision leading to those excessive developments that should take centre stage in the crisis narrative.

This diagnosis of the underlying causes of the crisis has important implications for our assessment of the crisis policy response. While the consensus summary concludes that "the whole situation was made much worse by poor crisis management", our view is that the "loans for reforms" rationale underlying the rescue approach was not only sensible, since it was the only way to successfully address the underlying causes of the crisis. It also worked and substantially improved matters. This even holds for Greece whose dismal performance in recent years is mainly a reflection of the fact that its economy has been far further off a sustainable path of economic development than had been realised before the crisis. And Ireland, Portugal and Spain have exited their rescue programmes and are recovering thanks to successful consolidation and structural reforms, and, of course, substantial monetary easing.

Most importantly, such a disagreement about the underlying causes of the EZ Crisis is destined to lead to a different view on how to best design an institutional architecture that is able to safeguard the Eurozone against future crises. Instead of correcting imbalances alleged to be excessive according to a fallible statistical procedure, in our assessment this framework should foster economic and fiscal policy discipline so as to avoid an excessive build-up of public and private debt, and effectively reduce moral hazard problems in the public and private sector.

In this chapter, we briefly outline such a framework, that we have developed in the context of the German Council of Economic Experts (of which we are all members). This framework, entitled Maastricht 2.0, has been developed by the German Council of Economic Experts (GCEE; *Annual Economic Report 2012*, paragraph 173 et seq.; *Annual Economic Report 2013*, paragraph 269 et seq.; for a more recent exposition, see GCEE 2015a).

A stable framework: Maastricht 2.0

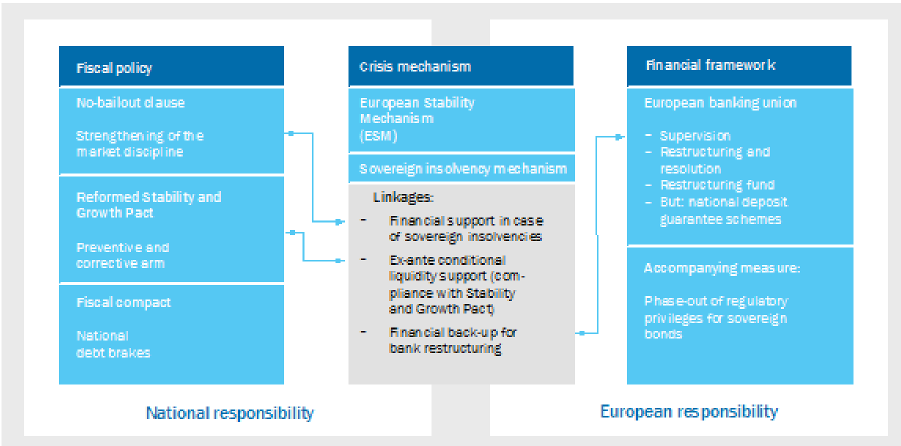
The distinctive element of any conceivable Eurozone architecture is the extent to which fiscal and economic policy competencies and liabilities are shifted from national to European level. Ultimately, the only convincing and robust candidate proposals are those ensuring that in each relevant policy field control over fiscal and economic policy action is accompanied by liability for the consequences of such action. Any divergence between these two aspects causes moral hazard and can result in serious political tensions.

With our Maastricht 2.0 concept, we propose creating a long-term regulatory framework that is consistent with this underlying principle (Figure 1). This regulatory framework follows the idea of crisis prevention first and crisis management second, and consists of three pillars structured according to the extent to which responsibility is allocated to European level.

Ensuring the stability of the financial system (right column of Figure 1): The danger of systemic financial crises justifies a strong governmental role for regulatory and supervisory authorities. In a system that predominantly relies on national responsibility, risks might easily be shifted from national level to the shared central bank balance sheet. It is therefore advisable to design common supervisory and resolution mechanisms at European level. Such arrangements are a key element of our concept of Maastricht 2.0.

The establishment of the European Banking Union during the last few years indeed created this previously missing counterpart to the common monetary and currency policy. Even though the banking union still needs to be strengthened by further reforms as outlined below, the broad transfer of supervisory, restructuring and resolution competencies to European level ensures the unity of liability and control.

Figure 1 A solid framework for the Eurozone: Maastricht 2.0



Ascertaining fiscal stability (left column of Figure 1)

Concerning fiscal and economic policy, two fundamentally different constellations would, in principle, be able to lead to an alignment of liability and control:

- The transfer of fiscal and economic sovereignty to the European level and simultaneously the assumption of comprehensive joint liability by the European partners.

This approach requires establishing an effective central decision-making authority at the European level endowed with the power to enforce tax increases, spending cuts and structural reforms, i.e., labour market and social policies, in a country if necessary (problem of intervention rights);

- The continuation of national sovereignty over fiscal and economic policy, excluding any joint liability for government debt.

This means that the no-bailout clause applies. Appropriate protection needs to be established to avoid that liquidity or solvency crises of individual member countries spread to the rest of the Eurozone, which may cause the no-bailout clause to be disregarded (problem of credibility).

In our assessment, any attempt to practically implement the first option, which would require Eurozone members to give up their national budgetary autonomy, is doomed to fail for the time being. Given the imperfect state of European integration and the manifold cultural, economic and institutional settings across the Eurozone, it is highly unlikely that a democratically legitimised transfer of fiscal and economic sovereignty to the European level will happen anytime soon. Any half-baked implementation of this option, however, with substantial national control remaining vis-à-vis joint liability, would be the worst of all worlds.

Therefore, we strictly advocate the second option of continuance of national sovereignty over fiscal and economic policy, even though we have to acknowledge that the credibility of the no-bailout clause is not easy to establish either.

For this reason, while fiscal policy should remain largely under national responsibility, according to Maastricht 2.0, member countries would be obliged to adopt responsible fiscal policy following three rules:

- The no-bailout clause strengthens market discipline by ensuring that private lenders – not the other member countries – bear the consequences of unsustainable fiscal policies;
- National fiscal policy is monitored on the basis of common fiscal rules defined by the Stability and Growth Pact (SGP) and infringements are seriously sanctioned; and
- National debt brakes and their monitoring prevent the accumulation of excessive public debt. The forthcoming development of the rulebook should underpin above all the credibility of the no-bailout clause.

Due to their intimate link with the state of public finances, the Maastricht 2.0 concept stipulates that key aspects of economic policy and the economic policy framework, such as the organisation of the labour market, also remain a national responsibility. Supplementary arrangements such as a fiscal capacity or a European unemployment insurance scheme, which partially shift the liability for irresponsible or imprudent national policy actions to European level, would not be consistent with this concept. Thus, member states remain responsible for structural reforms that lead to higher flexibility in their labour and product markets.

Over the course of the crisis, the SGP was effectively tightened, resulting in stronger European control of national financial policy. Five new provisions and one directive (the "Six Pack") were added in 2011, surveillance and coordination ("Two Pack") were improved and the fiscal rules were anchored at national level through the Fiscal Compact in 2013. These reforms have addressed the main shortcomings of the original SGP. Specifically, there is an additional focus on debt sustainability, in order to reduce the debt-to-GDP ratio when it exceeds 60%. Furthermore, they embody greater transparency and foresight, in particular with benchmarks for budget planning and the European semester. Finally, options for sanctioning have been expanded and a reverse qualified majority voting procedure has been introduced.

It has also become clear that the general economic and fiscal policy will remain to be regarded as a national responsibility for the time being. These developments have moved the regulatory framework of the Eurozone in the direction of our concept Maastricht 2.0.

Providing effective crisis management According to Maastricht 2.0, explicit rules should govern how member states' liquidity and solvency crises will be handled. Preparing for any ensuing crisis beforehand will have the important side-effect that the ECB will be prevented from feeling obliged to act as crisis manager, a step that will always be putting its independence at risk. The crisis mechanism in Maastricht 2.0 is designed to make funds available in a joint effort, but these funds can only be accessed with the approval of national governments and under strict conditionality. The rules should also ensure that government debt restructuring, if required to restore debt sustainability, proceeds in an orderly manner. The case of Greece suggests, however, that the exit of a member country from the Eurozone has to be possible as a very last resort.

The European Stability Mechanism (ESM), which was established during the crisis years, is a permanent crisis mechanism that provides financial assistance under strict terms in the event of crises that endanger overall EZ stability. Its resources are only available to countries that have ratified the Fiscal Compact. The release of funds requires a qualified majority of the votes in the ESM decision-making body, in which each member has a veto right. Thus, it comes very close to the crisis mechanism envisioned in Maastricht 2.0.

Remaining deficiencies of the Eurozone architecture

As indicated above, the reforms of the Eurozone architecture that were conducted during recent years are largely consistent with our concept Maastricht 2.0. We would therefore conclude that these reforms have already increased the stability of the framework. Yet there are a number of important deficiencies that still need to be corrected. Taking the current framework as the starting point of our discussion, all our considerations adhere to the objective of retaining the unity of liability and control. Most importantly, this requires rendering the no-bailout rule far more credible than in the past.

In addition to enhancing the future stability of the Eurozone, completing Maastricht 2.0 would relieve the ECB of its role as a crisis manager. As many of the recent reforms were implemented incompletely or too late, the ECB felt compelled to intervene, threatening to blur the line between monetary and fiscal policy. This particularly applies to the "whatever it takes" speech by ECB President Draghi and the related OMT announcement in summer 2012. Although it was effective, it can hardly be considered a sustainable situation.

Deficiencies to be corrected: Banking union

The effectiveness of the Single Resolution Mechanism (SRM) remains uncertain. The complexity of the decision-making structures could prevent a sufficiently quick reaction. Moreover, creditor participation is not yet fully credible due to a lack of commitment, thus not fully ruling out repercussions for governments in case of banking problems. The recent pushback against bail-in in Italy is telling in this respect. Discretionary leeway in creditor participation should be reduced considerably. Exceptions from creditor participation should only be allowed in the case of a systemic crisis and should be accompanied by high institutional hurdles (GCEE 2014 paragraphs 340, 357). Also, the resolution authority should be equipped with additional powers, so that it can also initiate and implement resolutions for smaller banks.

The reverse transmission channel of governments to banks has hardly been addressed thus far. The existing regulatory privileges granted to government bonds in terms of capital, liquidity and large exposure rules bias banks' investment behaviour toward investing in government bonds and thus affect government bond pricing. Since the start of the crisis, many banks, particularly in the Eurozone, have accumulated large exposures to domestic government bonds. Since banks might suffer severe losses in the event of a sovereign default, this makes the restructuring of government debt more difficult. Thus, high priority must be given to revising regulations regarding adequate regulatory capital and large exposure limits with regard to sovereign risks (for a detailed exposition and proposal, see GCEE 2015b). Similar regulations should also apply to insurance companies. While it is advisable to phase in these regulations gradually, a prompt decision on this reform would clearly be desirable.

Further improvement of the Single Supervisory Mechanism (SSM) is also needed. The combination of monetary policy and banking supervision in the ECB under the SSM carries the risk of conflicts of interest and objectives. This was evident, for example, in the ECB's approval of ELA loans in the case of Greece. Similarly, the close links between macroprudential supervision and monetary policy at the ECB may create conflicts of interest. The creation of an independent European banking or even integrated financial supervisor, which is institutionally independent from monetary policy and integrates micro- and macroprudential supervision, is desirable.

For now, we take a critical view of a common deposit guarantee scheme. As national economic and fiscal policy still have considerable influence on banking sector risks, a common deposit guarantee scheme harbours the danger of risks being transferred to the community of other member states. Before common deposit insurance can be considered, legacy problems would have to be solved and regulatory privileges of sovereign debt would have to be removed.

Deficiencies to be corrected: Crisis mechanism

While the ESM limits the risk of contagion effects, thereby increasing the credibility of the no-bailout clause, government creditors may undervalue risks due to the availability of crisis assistance. The ESM will not bring about full market discipline until it is complemented by insolvency proceedings for sovereigns, such that in severe crises a restructuring of sovereign debt becomes a precondition for ESM support. The current version of the treaty already mentions private creditor participation. However, this is limited to the mandatory assumption of collective action clauses (CACs) in government bond contracts that, however, do not automatically bind all outstanding government bonds. So far, these CACs have not led to a notable differentiation of spreads (Corsetti et al, 2015).

An insolvency mechanism for sovereigns that credibly stipulates a creditor bail-in would not only help with burden sharing (similar to the bail-in rules for the banking sector), but also give creditors incentives to assess the default risks of government bonds and loans accurately and factor them in when calculating risk premiums. This should result in ex -ante disciplining of government budgetary policy and would, thus, support crisis prevention. However, there could be an incentive for highly indebted countries anticipating the possibility of bailing in creditors to amass even more debt. Any restructuring therefore has to be accompanied by a macroeconomic adjustment programme that corrects these adverse incentives.

We have repeatedly discussed different possible designs for an insolvency mechanism for states. For details on its most recent proposal the reader is referred to GCEE (2015a,b). A key element of the proposal is a comprehensive debt sustainability analysis conducted by the ESM. If a debt crisis is asserted and there is no further capital market access, the ESM may give financial assistance on strict terms. If the ESM diagnoses a severe debt crisis, for example because the sustainability analysis demonstrates that a member country can only return to sustainable public finances via debt restructuring, there will be a one-time maturity extension of existing bonds and, if this proves insufficient, a debt restructuring.

It is undoubtedly preferable to execute any debt restructuring following an orderly procedure rather than ad hoc (Zettelmeyer et al, 2013). Our proposal is in many respects similar to the IMF proposal (IMF, 2014b), adding stricter rule orientation and reducing discretion. It is important to decide on the implementation of such an insolvency regime today to avoid it being postponed to an indefinite future. A transition period could be included during which the insolvency mechanism gradually comes into effect.

Debt reduction in the Monetary Union's member states would be a key step towards completing the Maastricht 2.0 crisis mechanism with a sovereign insolvency code. There have been proposals how to deal with legacy debt but there are no simple solutions (Pâris and Wyplosz, 2014; Corsetti et al, 2015). As the GCEE has explained, a European Redemption Pact would no longer work because of the existence of OMT (GCEE, 2013). Proposals to redistribute funds from countries with lower debt to countries with higher debt through a temporary transfer are not politically feasible, nor do they consider differences in debt sustainability. Lastly, fiscal transfers always create negative incentives for borrowers.

Thus, the responsibility for consolidating their public finances solely rests with the member states themselves. The legacy problem of public debts cannot be solved without a willingness to consolidate on the part of the highly indebted member countries. The fiscal pillar of "Maastricht 2.0" may help them in doing so.

Deficiencies to be corrected: The fiscal pillar

The reforms of the fiscal framework since the onset of the crisis have almost completed the fiscal pillar. The framework now in place is generally suited to improve the fiscal discipline of member states. Improvements are needed for the reformed fiscal pillar to effectively prevent a repetition of undesirable fiscal developments. The rules need to be simplified in order to limit destabilising discretionary leeway, such as in forecasting the economic cycle and structural budgets. It is particularly important for the credibility of fiscal rules that the responsible European institutions – Ecofin and the European Commission – consistently apply the existing rulebook in order to maintain fiscal discipline.

Tolerating temporary deviations, for example, in the cases of France being granted longer time to achieve the deficit limit under the SGP's corrective arm (European Commission, 2015a) and Italy for compliance with the 1/20 debt reduction rule under the SGP's preventive arm (European Commission, 2015b), is a repetition of past mistakes. Compliance in regard to reducing structural deficits is particularly important in view of the high debt ratios of many Eurozone members, which continue to hamper economic recovery and cast doubt on the stability of the Monetary Union. Even if not obvious to individual member states, the future of the Eurozone will depend on consistently reducing legacy debt.

The Greek crisis has demonstrated that the credibility of the no-bailout clause depends on the willingness of a member country receiving financial assistance to cooperate under the terms of an adjustment programme. If a country does not want to cooperate at all, its membership in the currency union is put into question. The exit of a member country from the Monetary Union is a violation of the treaty and thus of European law. This also applies to a member country introducing its own or a parallel currency. The Treaty on the Functioning of the European Union (TFEU) does not provide an exit option, because this could trigger speculation about exit from the Monetary Union among other member countries that have economic problems in the future.

However, the permanent lack of willingness to cooperate on the part of a member country could undermine the currency union's architecture to such an extent that its very existence is under threat. The currency union's member states would be susceptible to blackmail. In such cases, a country's exit from the Monetary Union must be possible as a last resort (ultima ratio). In this event, measures must be taken for the exit to be completed in an orderly manner and for the member country to receive economic support to avoid a humanitarian disaster.

Deficiencies to be corrected at national level: Insufficient structural reforms

The economic developments in Ireland, Portugal and Spain show that the adopted rescue approach – loans for reforms – has been successful (GCEE 2015a). Economic growth has been vigorous and unemployment rates have been declining. Structural reforms of the labour and product markets as well as of pension and social security systems are responsible for this success to a significant extent. Moreover, sluggish growth in Italy and France and lack of significant improvement in unemployment rates show that structural reforms there have been insufficient to date.

Structural reforms must be decided and implemented at national level in the member states' responsibility. Each member state's labour and product markets contain different provisions and regulations leading to different rigidities and barriers to entry that prevent competition from working properly. Member states can best tailor reforms to the particularities of their labour and product markets. Of course, such reforms are difficult to accomplish given the opposition of insiders in those markets obtaining rents from the current rigidities. It is the responsibility of each member state to overcome such opposition.

Especially Italy and France need bold structural reforms that provide new opportunities for private investors to earn profits in the future. Without such reforms, economic growth in these countries is very likely to remain sluggish. Moreover, recent elections in Portugal and Spain should not induce a reversion of the reforms already implemented so successfully. Similarly, member states currently in more favourable economic conditions should improve their labour and product market frameworks. This holds for Austria, Belgium and also for Germany.

Conclusion: Avoid premature integration

The concluded reforms have moved the Eurozone in the direction of our concept Maastricht 2.0 and have stabilised the Eurozone. But more needs to be done. All three pillars of Maastricht 2.0 – financial regulation, the crisis mechanism, and the fiscal framework – require further strengthening as outlined above. This concerns most of all a further strengthening of the resolution mechanism, a removal of regulatory privileges for sovereign debt, the introduction of an insolvency mechanism for sovereigns and an enforcement of existing fiscal rules. These measures need to be accompanied by further structural reforms to be decided on the national level.

Last year's turbulence in Greece should not be the cause for hasty moves towards closer integration. We repeat our criticism of proposals that cannot be reconciled with the unity of liability and control and instead stray further away from this principle. For example, the creation of a fiscal capacity at European level based on the concept of fiscal transfers from countries with above-average economic performance to countries with weaker economic performance is impractical in the light of measurement problems, creates false incentives, and harbours the risk of permanent unilateral transfers. This also applies to the potential creation of a European unemployment insurance scheme.

As long as member countries are unwilling to transfer national sovereignty over economic and financial policy to European level, all reform proposals must withstand a critical evaluation of the incentives they set for national economic and financial policy. The institutional framework of the single currency area can only ensure stability if it follows the principle of unity of liability and control. Reforms that violate this guiding principle plant the seeds for further crises and may damage the process of European integration, despite their good intentions.

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A sovereignless currency

Agnès Bénassy-Quéré[1]
Paris School of Economics, University Paris 1 Panthéon-Sorbonne, and French Council of Economic Analysis

The euro is unique in that it is a currency without a sovereign. Since the crisis, there have been major developments towards making the Eurozone more resilient, including the banking union and the European Stability Mechanism (ESM). This column explores whether further normalisation is required to make the Eurozone function properly. It argues that the Eurozone, unlike existing federations, lacks the ability to deliver counter-cyclical fiscal policies while complying with fiscal discipline. Macroeconomic coordination will thus require rules, a strong and independent European Fiscal Board, and the strengthening of the ESM.

Since the inception of the crisis, major progress has been achieved in the Eurozone to make it more resilient. Although still unfinished and not fully tested, the banking union will contribute to reducing systemic risks in the Eurozone, protecting taxpayers from residual risks, and attenuating the sovereign-bank risk loop. In parallel, the introduction of the European Stability Mechanism (ESM) has proved instrumental in dealing with sovereign debt crises through conditional financial assistance. Here again, the agenda is still unfinished since the ESM will hardly address a sovereign debt crisis in a large member state, and because the question of sovereign debt restructuring is still unsolved. Finally, the ECB has provided a powerful backstop to self-fulfilling liquidity crises through its commitment to intervene on secondary markets against adequate conditionality. Although still untested, the Outright Monetary Transactions (OMTs) have been a major stabilisation tool.

1 This short paper partly draws on Bénassy-Quéré et al (Forthcoming). It is however published under my sole responsibility.

These three major advances – banking union, ESM, OMTs – represent significant moves towards more sharing of both sovereignty and risk. In the case of the banking union, the responsibility for bank supervision is now shared at Eurozone level (through the Single Supervision Mechanism), whereas the residual risk is partially shared through the progressive building up of the Single Resolution Fund. For the ESM, risk sharing involved in financial assistance goes hand in hand through a form of 'federalism by exception' whereby the centre may impose an adjustment programme in times of crisis. As for OMTs, finally, sovereignty is clearly at the federal level whereas the purchase of troubled debts may involve some form of risk sharing to the extent that liquidity and solvency risks cannot be fully separated.

Such progress has been made possible by the commitment of member states to reduce the amount of risk at the bank level (through higher capitalisation), at the fiscal level (through the reinforced Stability and Growth Pact – SGP) and at the macroeconomic level (through the European semester and Macroeconomic Imbalance Procedure - MIP).

More fundamentally, these three innovations all work in the direction of normalising the Eurozone with respect to existing federations.

In existing federations, such as the US, Canada, Germany, or Switzerland, banking supervision is a federal responsibility; sub-national debt crises are generally solved through some form of conditional financial assistance from the federal level (except for very small entities, which are allowed to go bankrupt, see Corda et al 2015); and the central bank may purchase securities issued or guaranteed by government-sponsored agencies on the secondary market (although the bulk of existing sovereign bonds are federal debts, in sharp contrast with the predominance of national debts in the Eurozone).

The question then is whether these bold evolutions are sufficient, or whether further normalisation is required to make the Eurozone function properly.

The Eurozone remains an outlier

The Eurozone was conceived as a monetary union without a sovereign. It was just an arrangement between several member states to share monetary sovereignty, provided they commit not to abuse the system through fiscal profligacy. This arrangement failed. The response was to transfer an additional block of sovereignty (bank supervision), reinforce the rules of the game and introduce a layer of risk sharing. However, the €500 billion lending capacity of the ESM represents less than 10% of Eurozone members' combined budgets, whereas in the most decentralised federal country in the OECD – Canada – 24% of general government expenditures are decided at central level. More importantly, the ESM lending capacity is restricted to financial assistance to crisis countries, leaving aside traditional responsibilities of federal governments such as the funding of common public goods (infrastructure, defense, security, etc.), inter-individual transfers, and macroeconomic stabilisation.[2]

Common public goods

In the current organisation, the funding of common public goods is carried out at the EU level, as part of a budget totalising around 1% of the EU's GDP. This budget may be criticised in different ways. First, it may not address the priorities of a 'knowledge economy' (see Sapir et al 2004, Sapir 2014). Second, it covers a seven-year period (presently from 2014 to 2020), with limited flexibility. Third, although some of its programmes (such as the European Maritime and Fisheries Fund) may target sub-groups of countries, it needs to be approved by all EU countries, at unanimity.

The Eurozone will probably stay a sub-division of the EU for a long time. The question then is whether some Eurozone specific public goods should be financed at Eurozone level, separate from the EU budget. De facto, this is the logic of the ESM, whose mandate

2 As highlighted by Pisani-Ferry (2011), the ESM is a mutual assistance arrangement, not a common budget with delegated competences.

is to ‘produce’ a euro-specific public good, namely financial stability. Along these lines, the ESM could be reinforced to provide bridge financing to the Single Resolution Fund and to a future deposit (re)insurance fund. It could also provide precautionary credit lines to countries that comply with the SGP. This would reduce discontinuity triggered by an ESM programme, and it would alleviate the pressure on the ECB to use the OMTs in crisis times, especially when there is a risk of contagion.

Beyond financial stability, it is difficult to delineate a euro-specific public good. Eurozone countries have a specific stake in the free mobility of labour, which could justify targeted spending to safeguard this major achievement of the EU. However, the decision-making on these issues is not at the Eurozone level. Worse, not all Eurozone member states are part of the Schengen area. The EU is paying a high price for its choice of a multi-speed integration process.

Eurozone countries also have a stake in their partners’ growth rates. This is because low growth makes public and private debts unsustainable, raising the risk of a systemic crisis. However, GDP growth depends heavily on local policies, which raises the risk of moral hazard in relation to pro-growth spending. Except for specific projects with large spillovers, such as electricity cross-border connections, there is little scope for funding investment at Eurozone rather than national level.

Inter-individual transfers

In federal countries, social security spending is generally highly centralised, especially for public pensions and unemployment insurance (the degree of centralisation varies across countries for health care, family allowances and social assistance, see Escolano et al 2015).

As with any insurance system, social insurance should be designed behind the ‘veil of ignorance’ – individuals contribute to the system without knowing their personal exposure to the different risks, and the probability of each individual to see the risk materialise is the same across individuals. In federal countries, the distribution of the risks is made more even through harmonised rules for pensions or unemployment benefits across the different states or regions, harmonised labour market structures, and labour mobility. Despite such harmonisation, social 'insurance' often involves permanent transfers.

In the Eurozone, since no such harmonisation can be envisaged in the foreseeable future where permanent transfers are not politically possible, the scope for a common social insurance scheme is limited.

Macroeconomic stabilisation

In existing federations, macroeconomic stabilisation is generally the responsibility of the federal government. Fiscal stabilisation goes through federal tax receipts that increase in upturns, whereas federal spending is either neutral or counter-cyclical. The federal budget stabilises both idiosyncratic shocks and symmetric shocks. In the latter case, macroeconomic stabilisation involves fiscal deficits in bad times and surpluses in good times. In contrast, sub-national governments generally apply a budget balance rule whatever the economic situation.

In the Eurozone, macroeconomic stabilisation is devoted to member state budgets for idiosyncratic shocks, and to the ECB for aggregate shocks. As argued by Bénassy-Quéré (2015), this division of labour has largely failed for mainly three reasons:

(i) insufficient market discipline prior to the crisis;

(ii) neglect of financial risks with major spillovers on fiscal balances; and,

(iii) the inability of the ECB alone to address a massive negative demand shock.

The lack of fiscal stabilisation capacity is not specific to the Eurozone. Indeed, other OECD countries such as Canada, Australia and the UK also tend to run pro-cyclical fiscal policies, which show how difficult it is to design fiscal policies properly. In the Eurozone, the SGP puts limited pressure on governments in good times to reduce their structural deficits, whereas in bad times the rules become binding, and/or the market refuses to lend any more.

Normalising fiscal policy in the Eurozone with respect to existing federations would involve shifting macroeconomic stabilisation from state to federal level, and replacing the complex set of SGP rules by a simple budget-balance rule at state level. Allard et al (2013) suggest that the risk to lose access to the federal budget could raise the level of compliance of member states vis-à-vis both fiscal rules and policy recommendations.

However, launching a fully fledged Eurozone budget would entail far-reaching institutional changes, with a federal government (at least a finance minister), a federal parliament, a federal tax, and the ability to issue federal debt; with no guarantee that the discretionary part of the federal budget would really be counter-cyclical.

Additionally, there is a size question. According to Sørensen and Yosha (1998), the US federal budget smooths around 15% of idiosyncratic shocks to US state incomes.[3] The smoothing effect rises to 25% in Canada, but is only about 10% in Germany (see Allard et al 2013). These results are obtained with two-digit federal budgets (e.g., 20% of GDP in the US). The question then is whether a small Eurozone budget of say 2–3% of GDP would provide any significant macroeconomic stabilisation.

At first sight the answer is in the negative – if the federal budget is ten times smaller than in federal countries, the amount of smoothing should be about one tenth, hence 1–2.5%. It is surely not worth designing a complicated system, with political opposition and moral hazard problems, to obtain such a small smoothing effect.

However, federal budgets, which are the result of history, are generally not devoted to macroeconomic stabilisation. They cover the running of federal services, military spending, or permanent transfers that may not react to the macroeconomic cycle. In the

3 When a state income falls by 10% before federal taxes and transfers, it falls only by 8.5% on average after federal taxes and transfers.

Eurozone, a macroeconomic stabilisation scheme may be designed from scratch with the single objective of producing significant stabilisation.

Early proposals in this direction include Italianer and Vanheukelen (1992) who suggested that a member state whose unemployment rate increases by, say, 1 percentage point more than the Eurozone average (or falls by 1% less) would receive a transfer as high as 1% of GDP, an amount capped at 2% of GDP for a 2% unemployment gap. Inversely, member states enjoying an increase in the unemployment rate that is less than the average (or a fall that is greater) would pay a contribution (the amount being calculated so as to balance the system). As shown by Hebous and Weichenrieder (2015), Spain would have received transfers of 2% of GDP each year from 2008 to 2012, after having paid contributions of 1% in 2003-04 and 2% in 2005. Symmetrically, Germany would have received transfers over 2003-05 and paid a contribution of around 1% of GDP during the crisis.

One drawback of such system is that countries in bad times have to pay for countries in very bad times. This constraint is waived if the system must be balanced only over the cycle (not on a yearly basis). According to Hebous and Weichenrieder, applying a simple rule would have allowed the system to borrow around 0.8% of Eurozone's GDP in 2009, which could have significantly raised the amount of macroeconomic stabilisation.

Alternatively, temporary transfers may be based on output gaps (see Enderlein et al 2013). However, given the frequent revisions of the latter and the distance between output gaps and the real life of the people, this idea has received less attention than schemes organised around the unemployment rate. Indeed, recent proposals mostly focus on European Unemployment Insurance (EUI), with two main avenues – an 'all-time' system (e.g., Dullien 2013, Lellouch and Sode 2013) or a 'catastrophic' one (Gros 2014), the latter providing more stabilisation than the former but only for countries suffering 'big' shocks.

In order to contain moral hazard, however, most proposals include a system of clawback so that each member state would balance contributions and transfers received over the medium run. Hebous and Weichenrider note that clawbacks tend to move an insurance scheme into a borrowing one. The usefulness of such a scheme is doubtful for those countries not liquidity constrained. If member states are not prepared to pool some resources to really insure at least large shocks ('catastrophic' scheme), then it may be better not to pretend to set up an EUI.

Back to basics

The above discussion suggests that what is still missing in the Eurozone is the ability to deliver counter-cyclical fiscal policies while complying with fiscal discipline. The problem then is twofold:

1. There is no Eurozone budget, and suggestions to introduce one tend to degenerate de facto into a borrowing scheme once the constraint of moral hazard is introduced.
2. There are 19 national budgets, but they tend to be pro-cyclical or neutral, and at the same time to often violate fiscal rules.

One way forward would be to raise the incentives for national fiscal policies to be counter-cyclical, both in good times and in bad times.

In good times, a country complying with the SGP could nevertheless see its fiscal policy constrained by the MIP, in case there is a risk of overheating like in Ireland or Spain before the crisis. This would involve streamlining the MIP and making it more symmetric with respect to the SGP (see Bénassy-Quéré 2015).

In bad times, to the extent that the country retains market access, incremental investment and/or incremental unemployment spending could be temporarily excluded from the measure of the fiscal deficit. The corresponding expenditures would be put in an adjustment account, and introduced back into the deficit during the recovery.

Public investment is a good candidate to make fiscal policy more counter-cyclical, since it can generally be moved forward or backward with limited damage. As for incremental unemployment expenditures, they normally display a high multiplier. To the extent that the hike in unemployment is temporary, they do not involve any ratchet effect. Expanding unemployment spending during a crisis (and avoiding cutting investment to preserve social transfers) is a major challenge for macroeconomic stabilisation at the country level. There is much less rationale for adjusting other areas of public spending (such as education, health care, or security) over the cycle. On the revenue side, since stable tax rates are generally considered an important confidence factor, going beyond automatic stabilisers may not be appropriate.

At a later stage, a European unemployment fund could be set up at the Eurozone level in a similar way as in the US with the Federal Unemployment Tax Act (FUTA). Employers and employees contributions would be transferred to the national compartments of the fund, and the fund would transfer the benefits to the national insurance agencies. In case a Member state is temporarily in deficit, the Fund could make loans. If a member state is later unable to repay the loan, the contribution rate would be raised to balance the account over the cycle. Once national labour markets have significantly converged and confidence has been recovered, exceptional transfers could be delivered to specific countries suffering exceptional situations, as it is the case in the US.

The terms 'good times' and 'bad times' can hardly be carved in stone, nor can they be left to the decision of the politicians. The European Fiscal Board could play a key role to promote an independent view of fiscal policy in exceptional good or bad times, at national and euro-wide level. As argued by Calmfors and Wren-Lewis (2011) and Calmfors (2015), fiscal councils are a complement to fiscal rules – they allow operationalising more flexible, 'intelligent' rules. The 'flexibility' of the SGP with respect to economic activity could then be left to European Fiscal Board guidance rather than relying on 'rules in the rules'.

Based on the experience of five federal countries, Bordo et al (2011) consider a strict no bail-out clause to be instrumental in fostering fiscal discipline. However, Cordes et al (2015) find that the no-bail out clause is generally not applied to large sub-national jurisdictions, except if the national one is itself in crisis. Rather, sub-national jurisdictions receive federal assistance against adjustment commitments, which is the current approach of the ESM. In order to avoid self-defeating adjustment programmes, and because the ESM is not supposed to lend to insolvent governments, it is necessary to make a sovereign debt restructuring a real possibility by further strengthening the financial sector and its firewalls, and addressing the holdout problem. This is more important than designing debt restructuring rules that will also be difficult to carve in stone. In a sense, the debt restructuring scheme is already there. What is missing is the condition for it to be applied.

Conclusion

Can a currency survive without a sovereign? Probably yes, for some time, if macroeconomic coordination can build up a 'shadow' sovereign. Political legitimacy being national, governments will unlikely volunteer for more coordination. Hence the only solution is to rely on rules, complemented with a strong, independent European Fiscal Board, in order to strike the right balance between fiscal discipline and macroeconomic stabilisation.

Simultaneously, the ESM should be strengthened to back existing stabilisation tools (banking union, national budgets), and provide firewalls. A larger ESM would mean issuing more federal bonds that would also provide stabilising 'safe' assets.

In the medium term, the ESM could be turned into a fully fledged treasury that would manage a crisis fund (the ESM itself) and possibly other funds (unemployment insurance, investment, refugees…). The governance would have to be adjusted around a Finance Minister that would be accountable to the Eurogroup and to a Eurozone chamber of the European Parliament. Before such institutional changes can be made, at least the governance should be simplified through the generalisation of qualified majority voting at the Eurogroup and at the ESM board.

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The Eurozone's Zeno paradox – and how to solve it

Jean Pisani-Ferry[1]
Hertie School of Governance and France Stratégie

The dramatic episodes in the Eurozone in the past few years called for a number of policy reactions. Yet the response was usually limited to what was deemed indispensable to ensure survival. This column discusses how such half-solutions paved the way for future crises. The author also puts forward a few proposals regarding the Eurozone's policies. Among them are a European Monetary Fund, an overhaul of surveillance, the completion of banking union, an insolvency procedure for sovereigns, and Eurobonds of some sort. And the sooner such issues are deeply discussed, the faster coherent solutions can be reached.

Jean Monnet's famous statement – that Europe will be forged in crises, and will be the sum of the solutions to those crises – was prescient but inaccurate. The truth, for the Eurozone at least, is that Europe today is the sum of a few solutions and many half-solutions. Each of the dramatic episodes of the 2010-2012 period – the Greek call for assistance, the attacks on sovereign debt markets, the Greek insolvency, the feedback loop between sovereigns and banks, the reversal of capital flows, the break-up speculation – sooner or later triggered a policy reaction. Yet, because the member states did not agree on the diagnosis and the priorities, they limited their response to what was deemed indispensable to ensure survival - as clearly expressed by the *ultima ratio* doctrine. Time and again, half-solutions brought temporary respite but fell short of the

1 The usual disclaimer applies.

structural remedies that would have cured the fragilities revealed by the EZ Crisis. This paved the way for further crises and further responses.

The Eurozone was therefore long caught in its own sort of Zeno's paradox, until the near-simultaneous announcements of banking union and the ECB's Outright Monetary Transaction (OMT) scheme, later followed by the announcement of a major monetary stimulus, brought the storm to an end. In retrospect it is clear, however, that neither of these responses completely breaks with the Crisis pattern; absent a common fiscal backstop, banking union remains incomplete, and the OMT would not be able to address potential insolvency in a large country. Zeno's paradox is still there.

The case for comprehensive reform

The original paradox did not prevent Achilles from overtaking the Tortoise. But as observed by Guiso et al. (2014), politics may prevent the Eurozone from reaching completeness. Disagreements among governments represented the most significant obstacle in the early phases of the Crisis, but governments are not alone anymore: reservations on the side of public opinion are increasingly hampering ambitions for further integration. For this reason the Five Presidents' report (Juncker et al. 2015) is remarkably elusive about the end-goal. But far from dispelling fears, the absence of a blueprint for the future and the lack of serious discussions about its possible content are in fact fuelling the citizens' concerns. The perspective of another round of crises that will result in another set of half-solutions is probably the most frightening that can be offered to the citizens.

The euro's survival currently hinges more on the fear of the dire consequences of a break-up than on the expectation that it will deliver stability and prosperity. This is not a stable equilibrium. To keep the future fuzzy while kicking the can down the road cannot be a winning strategy. Times may not be auspicious for an ambitious agreement, but at least ambitious discussions should be held on alternative blueprints for the future. As things stand, Europe may not be able to reach consensus on a plan for the future of the euro, but it needs a consensus view on issues that must be solved and the alternative options that can be considered.

Three types of reforms were introduced in response to the euro crisis.

- First, a crisis management system was put in place, with the creation of the European Stability Mechanism (ESM) and the introduction of the Outright Monetary Transaction (OMT) scheme.
- Second, a series of new rules and procedures were introduced with the aim of strengthening and broadening the surveillance regime.
- Third, banking union was initiated.

Crisis management

The creation of a crisis management arrangement was an indispensable addition to the policy system. The policy prescriptions of the Troika have been a matter for controversy, but the conditional financial assistance arrangement has proved effective.

There are questions, however, about its future. The Troika is an ad-hoc association of institutions whose statutes, mandates, and accountability differ significantly. Time has come to create on the basis of the ESM a European Monetary Fund (with seconded staff in time of crisis) that would enjoy more policy autonomy and be accountable to parliament. Assistance decisions should be taken by qualified majority rather than unanimity. Furthermore, the Eurozone should rethink the conditions for assistance. It is not by accident that the IMF has created a range of facilities with different degrees of conditionality whereas the *ultima ratio* principle precluded it in Europe. Earlier intervention, before a country loses market access, contingent credit lines for prequalified countries and lighter conditionality could save jobs and money.

Surveillance

The piling up of fiscal, economic, and financial surveillance procedures has made the system of policy rules undecipherable even for insiders. For this reason there is little ownership of it among national policymakers, and even less among national parliamentarians – not to speak of public opinions. On the economic front, the Macroeconomic Imbalances Procedures (MIP) has failed to address significant current-account imbalances. On the financial front, the creation of the Single Supervisory Mechanism for banks is a major reform but macroprudential supervision has not delivered much. On the fiscal front the superposition of deficit and debt rules, of nominal and structural benchmarks and of Stability and Growth Pact and TSCG procedures has resulted in extreme complexity. Furthermore, the interpretation clauses recently added by the Commission with the aim of introducing some flexibility in the implementation of the SGP (European Commission 2015a) have added to the opacity of the set of rules. The perceived legitimacy of the policy system is low and the credibility of eventual sanctions remains questionable. There is a growing risk that a government will call the bluff and openly defy the Eurozone's fiscal rules.

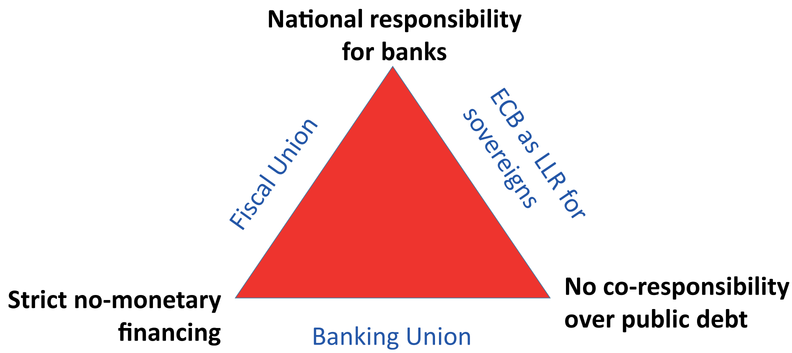
The question for the future is one of strategy; should the system of rules be strengthened again? Or would discipline be more effective if decentralised? The creation a few years ago of national fiscal councils and the recent Commission proposal for national competitiveness boards (European Commission 2015b) have been first steps in the latter direction. Domestic institutions that are rooted in, and attuned to the national policy system are more likely than rules coming from above to elicit ownership of the disciplines inherent to participating in a currency union. They can also be much more granular in their recommendations, be it as regards budgetary and fiscal decisions or as regards those affecting wage-setting and price formation. They can balance the need for overall policy consistency at Eurozone level and the need for adaptation to specific national contexts.

The evolution towards decentralisation should be pushed one step further. The remit of the national fiscal councils should first be broadened to encompass issues such as the assessment of tax and expenditures forecasts, the costing of measures submitted to parliament and debt sustainability analysis (some have already been assigned such responsibilities, but not all). Second, governments should be encouraged to rely more on the expertise of these councils, which could be done gradually by granting countries equipped with authoritative institutions more room for manoeuvre within the framework of the Stability and Growth Pact. This would give government an incentive to abide by domestically rooted fiscal discipline principles. Third, these councils should be encouraged to emulate competition authorities and sector-specific regulators, work as a network and develop common methodologies. Although its independence from the Commission and mandate are currently a matter for discussion, the future European Fiscal Board (European Commission 2015c) should function as a hub for this network. The same model would apply to the competitiveness boards.

Radical proposals go much further in the direction of decentralisation. Mody (2013), among others, suggests that governments should be left free to behave as they wish, provided the no bail-out clause is made credible and a sovereign insolvency procedure is put in place. In the view of the proponents of such solutions, the Eurozone should emulate the US and accept the possibility of bankruptcy of a sub-federal entity.

There is logic in such proposals. They are consistent with the landmark 2012 decision to protect sovereigns and banks from mutual contagion by severing the financial link between them and establishing to this end a banking union. Back then the Eurozone was facing the trilemma between national responsibility for banks, strict no-monetary financing and no co-responsibility over public debt (Figure 1). This bind could have been solved by endorsing fiscal union or by giving explicitly to the ECB the role of a lender of last resort for sovereigns. The choice, in principle at least, was rather made to launch banking union.[2]

Figure 1 The 2012 trilemma



Source: Pisani-Ferry (2012)

Banking union

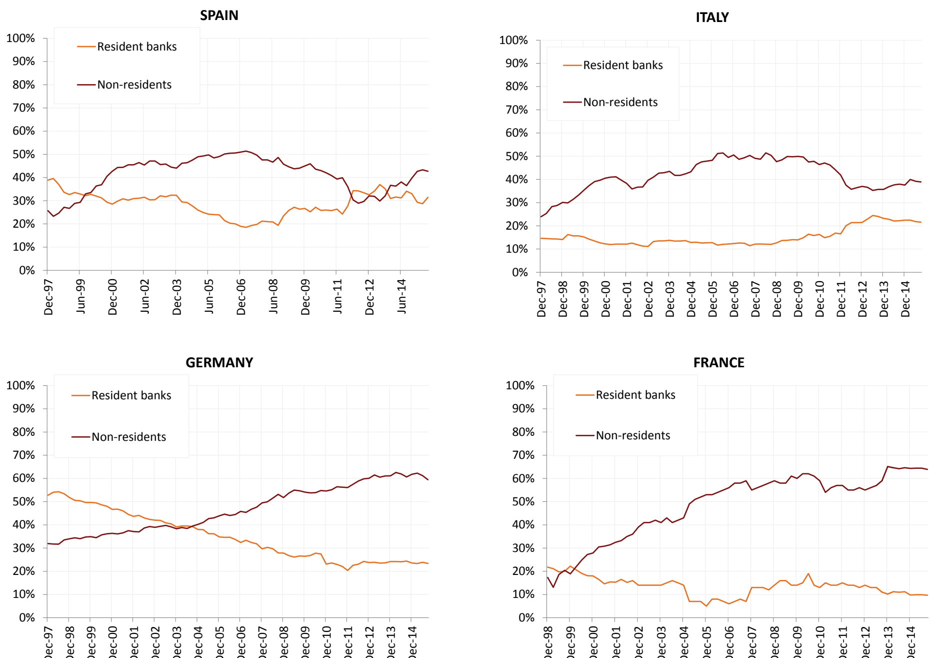
This agenda has not been completed yet. Single supervision and resolution have been major systemic reform steps, but the link between banks and sovereigns has not been fully broken. To start with, banks in vulnerable countries are still more heavily exposed to their sovereigns than they were on the eve of the Crisis (Figure 2). This implies that a government debt restructuring would have lethal consequences for the banking system. Only a diversification of their government bond portfolios triggered by exposure limits or regulatory incentives to holding synthetic securities would ensure that banks are protected from the consequences of such an event. Symmetrically, despite the creation of the resolution mechanism, sovereigns are still exposed to the catastrophic risk of shouldering the cost of a banking system rescue. True, the Crisis has changed the policy philosophy and public money is not anymore the first line of defence against the risk of bank failure. But it remains the last line of defence and for this reason sovereigns will remain exposed as long as this risk has not been mutualised. What matters for

2 It must be acknowledged that the choice was less clear-cut than announced in June 2012. Although the ECB was not given the role of a lender of last resort for the sovereigns, the announcement of the OMT was widely interpreted as a commitment to block self-fulfilling speculative attacks against sovereign borrowers.

markets is who bears the ultimate, catastrophic risk. Recent experience suggests that the political feasibility of bail-ins remains challenging.

The logic of the solution to the trilemma adopted in 2012 – banking union – therefore ultimately calls for two further, mutually reinforcing reforms: exposure limits for banks and a common fiscal backstop.

Figure 2 Shares of domestic banks and non-residents in total holdings in government bonds, 1997-2015



Source: Bruegel, Sovereign bond holdings dataset

Assuming these reforms are put in place, could the Eurozone function in the same way the US does and let a participant state go bankrupt? There are strong reasons to doubt. The debt of the state of California, the largest in proportion of US GDP, amounts to less than 1% of it, whereas the debt of Italy amounts to 20% of Eurozone GDP. A bankruptcy of the former could be an easily manageable financial event. This would not be true for the latter.

Sovereign insolvency

This is not only a matter of legacy. In the US policy system, fiscal stabilisation is assigned to the federal government and state governments are subject to individual deficit and debt limits. In the Eurozone, however, it is assigned to the national level and for this reason alone governments face a permanent trade-off between discipline and stabilisation. Systemically, it is hard to imagine a Eurozone where the national governments' debt would be as negligible as it is in the US. Benign neglect cannot apply.

From these observations does not follow that the Eurozone does not need an insolvency procedure. The combination of extremely low inflation, miserable growth, high national public debt, and the absence of a federal budget that could take on stabilisation and risk management functions implies heightened risk of sovereign insolvency. Furthermore, the absence of an explicit procedure for dealing with situations of insolvency undermines the credibility of fiscal discipline.

So far, however, Eurozone authorities have rejected calls for a corresponding procedure, claiming instead that Greece was and would remain an exceptional case.

For reasons of effectiveness, completeness, and credibility, time has therefore come to reconsider the approach to sovereign insolvency. First, conditional financial assistance of the sort provided to Greece and other countries would be made more effective and less costly if it implied the automatic maturity extension of maturing private claims. Second, as the introduction of exposure limits for banks will deprive sovereigns from access to 'their' banks and make some of them more fragile financially, predictable solutions that reduce the social cost of state insolvency would help make such an event less damaging economically. Third, only an insolvency procedure can ultimately make the no bail-out clause credible and insulate policy-motivated government bond purchases by the ECB from support to an insolvent sovereign.

An insolvency regime should not be regarded as an automatic, rules-based procedure for determining when debt should be restructured. Sustainability assessment requires both objectivity and judgement and a decision to restructure can only be taken once the interests of all interested parties have been taken into account (Gianviti et al., 2010).

The introduction of an insolvency procedure in a high-debt, low-diversification context is admittedly a delicate venture, to say the least. For it not to result in a shock to the banking system, it should be preceded by a diversification of bank balance sheets. But an insolvency procedure, a common fiscal backstop and exposure limits for banks would be mutual complements. For this reason they should be considered as components of the same reform agenda.

Stabilisation

The last question relates to stabilisation. The Maastricht assignment made individual member states responsible for responding (within the limits set by the Stability and Growth Pact) to idiosyncratic shocks, while monetary policy was given the role of responding to common shocks. In exceptional cases, like in 2009, coordinated fiscal responses would supplement monetary policy, but this was supposed to occur rarely. In such a setting, there was no macroeconomic need for a common fiscal capacity.

There is a significant risk that this arrangement will prove insufficient in the years to come. The effectiveness of monetary policy is being hampered by the near-zero inflation and real interest rates environment. To the extent such an environment is likely to persist (and there are reasons to fear that low real rates, at least, are here to stay), any monetary support will have to rely on unconventional measures only. Furthermore, the next Eurozone recession could hit before monetary policy has started to normalise, which means that a proper response would require new unconventional measures over and above those already in place. The chances that monetary support would prove insufficient are not to be neglected.

On the fiscal side, however, there is a risk that governments will prove unable or unwilling to provide fiscal stabilisation. Constraints set by the EU fiscal framework, high debt levels, and the vivid memory of the 2010-2012 attacks on sovereigns may all push governments to err on the side of caution. True, this should not apply to Germany, but Berlin is unlikely to be willing to provide fiscal support for the whole of the Eurozone.

In a near-zero inflation environment, an under-provision of both monetary and fiscal support when confronting a recession would carry significant macroeconomic risks. In addition, it would undermine political support for monetary union in testing times. For these reasons the Eurozone should prepare and reflect on how this gap could be filled.

Several proposals for creating a Eurozone budget have been put forward, for example by French Treasury officials (Lellouch and Sode 2014). Whether or not there is a public finance rationale for a common budget is an issue that should be examined in its own right, independently from its possible stabilisation role. It is doubtful, however, that such a budget could reach a size that would make its stabilisation role a meaningful complement, let alone a substitute to that of national budgets.

One option to overcome excessive risk aversion at national level would be to facilitate access by individual member states to a low-conditionality borrowing facility. It has already been mentioned that a shortcoming of the current crisis management arrangement is the lack of such a facility. Support could come either from an ESM credit line or in the form of a joint borrowing tranche as proposed in Enderlein et al. (2012). Granting prequalified states the unconditional right to issue a pre-determined amount of Eurobonds (to be followed, if needed, by a low-conditionality tranche and then by an ESM programme) would go a long way towards rescuing the Maastricht assignment.

An alternative would be to supplement national fiscal stabilisation with a common borrowing scheme that could be activated when facing especially adverse circumstances. In practical terms the ESM borrowing capacity could be enlarged so that it could be activated for the financing of investment projects. This would also amount to the issuance of some form of joint bonds, but with the aim of financing Eurozone spending rather than of helping individual states. One way or another, additional risk-sharing looks to be a necessary dimension of the response to the shortcomings of stabilisation in the Eurozone.

Conclusions

The proposals put forward in this note are admittedly ambitious: a European Monetary Fund; an overhaul of surveillance; the completion of banking union; an insolvency procedure for sovereigns; and joint bonds, or Eurobonds of some sort.

Clearly, such an agenda is bound to be controversial and is unlikely to be endorsed any time soon. The role of such proposals is not to command instantaneous support, however. It is to highlight issues, to outline coherent solutions and to elicit serious discussions about them. Again, what the Eurozone needs to escape its Zeno's paradox is a genuine discussion about its long-term future.

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Part 2

Focusing on completing the Banking Union, and financial markets

Completing the Banking Union[1]

Daniel Gros
Centre for European Policy Studies

The Eurozone's 'Banking Union' created a system of banking supervision and a common institution to restructure troubled banks. There remain two issues, however, that need to be addressed: banks are holding too much debt of their own sovereign, and deposit insurance is only backstopped at the national level. This column argues that these issues need to be addressed simultaneously for economic and political reasons. Specifically, periphery and core countries hold opposing positions on remedies to the respective problems. A combination of the two makes economic sense and could represent an acceptable political compromise.

The consensus narrative (Baldwin et al. 2015) concluded that "Tthe "EZ Crisis was a 'sudden stop' crisis". The government debt crisis came later and was a consequence of the sudden stop, as can be seen from the fact that "[A]part from Greece, the nations that ended up with bailouts were not those with the highest debt-to-GDP ratios" (Baldwin et al. 2015).

What made the crisis so costly in terms of output and employment was not the higher risk premia on government debt per se, but the tight link between governments and bank finances, combined with the predominance of bank financing throughout Europe. The 'doom loop' acted as a crisis amplifier whereby weak governments increased the cost of financing for banks and the difficulties of banks then depressed the economy, which then weakened both governments and banks even further.

1 Eichengreen, B and C Wyplosz (2016), "Minimal Conditions for the Survival of the Euro", Intereconomics 51(1): 24-28, January/February..

EZ leaders finally recognised this problem when they decided in the summer of 2013 to create a system of banking supervision and a common institution to restructure banks in difficulties. This combination has been dubbed 'Banking Union', but, while important and helpful, what has been done so far is not sufficient to prevent the recurrence of crisis. The Banking Union should be completed and complemented with other measures to weaken the link between national governments and national banking systems.

Two issues in particular need to be tackled:

1. Banks hold too much debt of their own sovereign. A sovereign default would bankrupt the banks in the country (e.g., Greece).
2. Deposit insurance has been left in national hands with only a national back-up. But if there is a national crisis the government might not be able to provide a credible backstop for deposits (e.g., Ireland).

The two issues need to be tackled in tandem for economic and political reasons, but the required solutions are quite different in nature – diversification of sovereign debt holdings can be enforced by a low-level change in some obscure details of banking regulation (and maybe even by the ECB on its own). A common deposit insurance requires the creation of a new institution.

Diversifying sovereign risk

The first problem (excessive holdings of own government debt) seems relatively straightforward, but any sensible solution encounters strong political resistance.

The instability created by large holdings of sovereign debt by banks has been widely recognised – most recently see the Advisory Scientific Committee (ASC) of the European Systemic Risk Board (ESRB). The problem is not how much government debt banks hold, but the concentration. In many countries banks hold debt of their own sovereign equivalent to more than 200% of their capital. This means that any sovereign restructuring would bankrupt the banking system. Formal sovereign defaults are rare, but even a sharp increase in the risk premium, which would depress the market price of long-term debt, would bring the banks into difficulties.

An example can illustrate the importance of this feedback mechanism – risk premia of 5 percentage points (as reached by Italy or Spain at the peak of the crisis) can reduce the market value of long- term government debt by almost 40%. Given that Italian banks held about 250% of their capital in Italian government debt, this risk premium would wipe out their capital. (Banks are not required to mark their holdings of government debt to market. The official capital ratios were thus not affected by the risk premium. But the market saw through the official balance sheets and marked down Italian banks).

The situation of Italian banks would have been quite different if they had held a diversified portfolio of EZ government debt. In this case the fall in value of peripheral government debt would have been compensated by an increase in the value of core-country debt (the price of German debt went up as capital fled back from the periphery). It would not have mattered whether the banks had held 250% of their capital or even more in government debt – with appropriate diversification, the high and variable risk premia during the euro crisis would have had little differential impact on the solidity of banks in different countries.

The key problem is thus the concentration of sovereign risk on bank balance sheets, not how much government debt banks hold (see ASC and Gros 2013a).

How could this diversification be achieved? Banking regulation already embodies the general principle that banks should not be exposed to any one debtor by an amount greater than a quarter of their capital. The purpose of this general rule is clear – the insolvency of any one debtor should not put the entire capital of the bank in jeopardy. Unfortunately, this rule is not applied to sovereigns. Gros (2015) and others have thus proposed simply applying this general 'large- exposure' rule to government debt as well. Others have proposed the creation of a synthetic EZ government debt by securitising a basket of EZ government debt 'Euronomics' (see De Groen 2015).

Action along these lines is thus needed. Until now it has proven impossible to get governments to agree on some diversification rules for bank holdings of government debt because every government likes to have its own banks as captive customers for its own debt. Moreover, banks (and governments) in the periphery would lose the income they earn by holding the higher- yielding bonds of their own government. This is important for the banks – even if the difference between national government debt and the EZ average is only 1-2 percentage points, holdings of national government debt (instead of a diversified EZ portfolio) would mean a lower return on equity of between 2.5 to 5 percentage points. Given that the return on equity is in single digits in any event for many banks today, this represents an important loss for shareholders. But dealing with the second issue, deposit insurance, could provide a way to overcome this resistance.

Deposit insurance

The report of the five presidents argued that a banking union should not only encompass common supervision and a common restructuring mechanism, but also needed a common defence of retail deposits to prevent bank runs. This is the case in the US. Gros and Schoenmaker (2012) argue that one should work backwards from the end game – when a bank is failing and depositors need to feel protected – to restructuring as a way to avoid outright failure, and supervision to ensure that banks do not take undue risks.

However, this does not imply that resolution and deposit insurance should always be located in the same institution with the Federal Deposit Insurance Corporation (FDIC).

In reality, resolution and deposit insurance are of a quite different nature; and the rationale for fully centralising deposit insurance is much weaker than that for resolution. The purpose of bank resolution is to avoid insolvency, with all the costs and contagion effects it might generate. Resolution thus aims to ensure continuity of those main functions of a bank that are deemed to be of systemic importance. Public funding is needed only to the extent that no private-sector solution can be organised on short notice. The purpose of a resolution fund is to finance investment in a new bank (to be carved out of the failing one) – not to give money away. A well-run resolution fund should thus be profitable. By contrast, a deposit insurance fund can only make losses, as it is used when a bank has failed and the losses are so large that depositors cannot get their money back. In short, a resolution fund invests in the future, whereas a deposit insurance fund pays for losses from the past.

Several European banks have very large balance sheets, close to one year's worth of national output. But large banks active in several member states would represent a problem for any national resolution fund – though much less for national deposit insurance funds, since any one of them would only have to make good on the losses suffered by resident depositors (provided the retail operations are organised via subsidiaries, rather than branches). By contrast, resolution funding is needed for the entire group. This is another reason why a single resolution fund is needed for large, internationally active banks, but not necessarily a single deposit insurance fund.

Moreover, the direct benefits of insuring depositors are quite local, as cross-border retail deposits remain rare. It thus makes sense to keep the cost local as well. All this implies that the argument for centralising deposit insurance is much weaker than for bank resolution.

The one public function that national deposit insurance funds are not well equipped to perform is that of maintaining the confidence of depositors when the entire banking system of a country is under stress. In a systemic (at the national level) banking crisis, the accumulated funds in the national deposit insurance scheme are likely to be insufficient. But the government of the country in question is likely to be under pressure as well, which implies that the national fiscal backstop is likely to be weak when it is needed most.

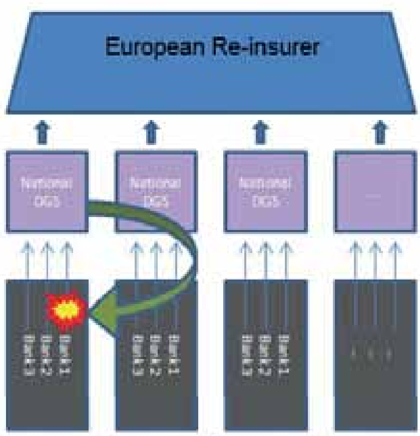
This implies that what is needed to complete the Banking Union is a system to ensure the stability of the national deposit insurance system – in other words re-insurance (for large, systemic shocks at the national level). The Commission proposed a variant of this re-insurance approach in December 2015.

The re-insurance approach: A schematic presentation

Under the pure re-insurance approach, national deposit guarantee systems (DGSs) would continue to function as before, but each one would be forced to take out insurance coverage against large shocks. This (re-)insurance could be managed under the European Deposit Insurance System (EDIS), as it is called in the Commission's proposal. The funding for the re-insurance could come from a common fund (like the Deposit Insurance Fund, DIF, also proposed by the Commission).

The funding for the DIF in turn would come from the national DGSs, which would have to transmit part of the fees they are levying on individual banks to the DIF at the European level). Schematically there would thus be two tiers of deposit insurance – the national DGSs in relationship to 'their' banks, and the European re-insurer in relationship to the national DGSs.

Figure 1 The two-tier approach to deposit insurance: Re-insurance



This two-tier system would react differently to the failure of a small bank than to a systemic problem at the national level. This is illustrated in Figures 2 and 3.

Figure 2 The case of a single bank failure

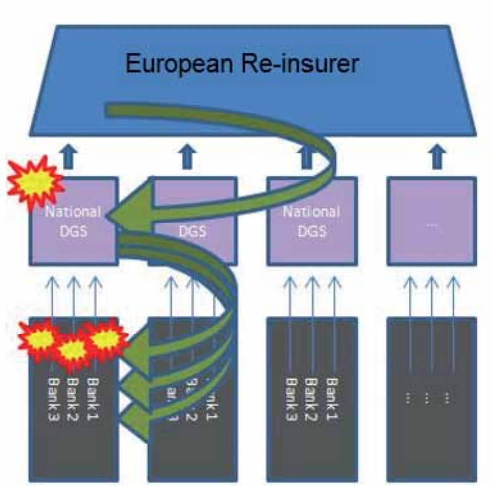
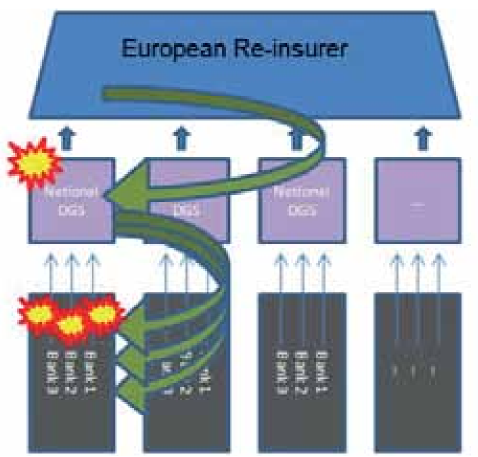


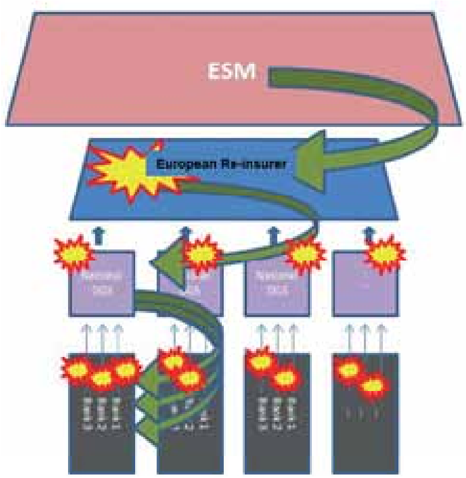
Figure 3 Systemic crisis at the national level



The European re-insurer (i.e., EDIS with its fund, the DIF) would thus intervene only if so many banks fail in any given country such that the national DGS would be overwhelmed.[2]

It is clear that the resources of any normal deposit insurance will always be too small in the event of a systemic crisis. This also applies for the EZ as whole. If there is a systemic crisis at the EZ level (as opposed to a national crisis), any European insurance scheme would need a fiscal backstop. This applies to the re-insurance approach as well as the case in which there would be one single European deposit insurer. Figure 4 depicts schematically the case of an EZ-wide crisis, assuming that the ESM would constitute the fiscal backstop.

Figure 4 The case of an EZ-wide systemic crisis and the need for a fiscal backstop



2 The one risk that cannot be properly priced and prevented is that of re-denomination, or rather exit from the euro. It is clear that no common deposit insurance could be asked to fully pay out €100,000 to all depositors in a country where the government has decided to re-introduce a national currency. The 'Grexit' problem cannot be solved either by fully centralised deposit insurance or via the re-insurance approach. The only solution one can imagine is that any country that leaves the euro will have to rely on its national DGS, which could claim from EDIS and the DIF only the amount of premia it had paid in previously.The European Re-insurer should thus be backstopped by the ESM. This would be a natural evolution of its role since it was set up to backstop countries and can already now lend directly for banking resolution.

Macro risk-pricing and alternative private-sector solutions

One key aspect of the reinsurance approach is that it is a macroeconomic function. Its main concern will not be the risk parameters of each individual bank in each country, but rather the systemic risk that arises from developments at the macroeconomic level (such as rising housing prices, increasing leverage in the corporate sector, etc.). In principle, this expertise is already available in the European Systemic Risk Board (ESRB). It would thus be important to find an institutional solution under which this expertise can be used. Moreover, procedures to prevent systemic problems already exist; for example, the Macroeconomic Imbalances Procedure (MIP) and the Growth and Stability Pact (GSP). The macroeconomic aspect will remain a predominantly national responsibility for a long time, driven by national fiscal policy, wage developments, the fiscal treatment of housing, etc. These are the risks that would be priced under the re-insurance approach.

Pricing macroeconomic risk will always remain imperfect, but some risk pricing is better than none. Gros (2015) illustrates how one could introduce an element of 'experience rating' to minimise the scope for cross-country transfers if that were to prove politically needed.

One could argue that the re-insurance of (national) DGSs could also be achieved through a private-sector solution, in a similar way to how re-insurers provide cover against large risk to insurance companies. However, a private-sector solution is unlikely to work in this area because the risk is primarily of a macroeconomic nature.

Moreover, the capital base of even the largest re-insurance companies is only around 25 billion euro, not sufficient to provide a back-up even if only a medium-sized country experienced a systemic crisis. By contrast, the DIF would be able to count on the back-up of the constituent national DGS whose combined funding potential will be closer to 80 billion euro.

Moreover, the largest reinsurance companies are European, and would thus likely be in a difficult situation themselves in the case of a systemic crisis affecting the entire EZ. This is what happened to the so-called monoline insurance companies in the US, whose primary business had been to insure the debt of municipalities, but which had insured bonds based on sub-prime mortgages. Those most involved in this business went bankrupt when the US housing market tanked in 2008/9.

Conclusions

Nation states are usually able to deal with small shocks themselves, but they need support when the shock is so large that access to the capital market is impaired (Gros 2014). In completing the Banking Union, one should heed the lessons from the economics of insurance and provide protection against large, systemic shocks. Nation states could remain responsible for deposit insurance for the occasional individual bank failure. But a common fund is needed to provide re-insurance when the shock is so large that it would overwhelm national resources.

A similar principle should be applied to banks – they should be able to survive the failure of any one of their debtors, including the failure of their own government. But this means that banks should not be allowed to lend more than a fraction of their capital to their own government.

Peripheral governments still resist mandatory diversification of sovereign risk for banks, but would like more risk-sharing through a common deposit insurance. Germany has taken the opposite position. The package of sovereign-risk diversification by banks and risk-sharing through re-insurance of deposit insurance could represent a political compromise that makes economic sense as sovereign risk diversification by banks would lower the danger of systemic crisis caused by imprudent fiscal policy.

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Safeguarding the euro – balancing market discipline with certainty

Thorsten Beck
Cass Business School, City University London, and CEPR

A lot has been achieved in terms of institution building to turn the Eurozone into a sustainable currency union. The Eurozone Crisis, however, has shown that the Eurozone is still not a properly functioning currency union. This column points to three areas of further reform to achieve such a goal. These include the disentanglement of sovereigns and banks, completion of a banking union, and an institutional convergence for a fully integrated financial system.

A lot has been achieved over the past years in terms of institution building to turn the Eurozone into a sustainable currency union. The Greek crisis of 2015, however, has also shown that the institutional framework is not sufficiently strong yet. While there is the feeling that the worst of the crisis is over and that the Eurozone is much better equipped to confront future shocks, the Eurozone seems still far away from a properly functioning currency union.

A long-term sustainable monetary union has to combine a minimum degree of market discipline with a minimum degree of certainty to achieve market-based risk sharing. The former is to force markets participants to price their claims according to risk. The latter is to hedge against catastrophic risk, realising that government has a comparative advantage in providing certainty but also regulatory discipline. Ultimately, the right balance of market discipline and providing certainty is up for discussion – at this stage I will only argue that a healthy portion of both is needed.

Lots of progress has been made in the area of market and regulatory discipline, including bail-in rules for banks, the Comprehensive Assessment of banks as entry point for the SMM and actual bail-ins of junior bondholders in bank failures and restructurings across the Eurozone. It seems, however, that not as much progress has been made on institutionalising certainty – the certainty of stable banks and of re-denomination risk is currently borne primarily and almost exclusively by the ECB, summarised in the famous words: Whatever it takes.

This column points to three areas of further reform needs to achieve a more appropriate balance of market discipline and certainty:

- Completely disentangle sovereigns and banks;
- Complete the banking union; and
- Institutional convergence for a fully integrated financial system

Disentangling sovereigns and banks

It seems almost obvious that there will be another stand-off between creditors and the Greek government in the near future. The critical problem is if this stand-off will put into question yet again the Greek membership in the Eurozone or whether it will rather resemble the Puerto Rican stand-off between government and its creditors. One big difference is that in Puerto Rico private-sector creditors sit on the other side of the table, though their political influence is strong enough to influence the actions of the federal government in Washington DC. As – or even more – important is, however, that the solvency and liquidity of Puerto Rican banks does not depend on the solvency or liquidity of Puerto Rico's government, unlike in the case of Greece. Only when Greek depositors can be completely confident that their euros will be safe – in the form of euros – in Greek banks whatever happens to their government's solvency and liquidity position, they will NOT run on the banks at the slightest sign of fiscal policy trouble. The task is thus to separate governments and banks, in reality and in perception. It is almost too obvious to state – and so I will not focus on this – that continuous talk about a Grexit will undermine this task, but there are other important steps to be taken.

First, 'europeanise' Greek banks; i.e. there should be no influence of the Greek government authorities or the Greek central bank over the domestic Greek banks. The recent ouster of the CEO of one of the major Greek banks clearly shows that this has not been achieved yet. Even the impression of a link between government and banks, however, will put in question the solvency and liquidity of Greek banks, if and when the Greek government gets into trouble.

Second, the ECB should not be part of the Troika and thus creditor of the Greek government, as it faces a clear conflict of interest by: being a lender to the Greek government; supervising the banks that hold Greek government bonds; and having the task to keep Greece within the Eurozone. This conflict of interest came clearly to light during the recent stand-off in July when the ECB had to decide on a daily basis whether to extend liquidity support for the Greek banks or not, based on (in)solvency assumptions of the Greek banking system, which in turn depends on assumptions about the solvency of the Greek government.

Third, regulatory safeguards have to be strengthened to disentangle governments and banks. This would require putting concentration limits on government bonds of any government, similar to single borrower exposure limits. In the long run, the development of non-bank financial institutions will help by diversifying the holdings of government bonds across a large array of investors.

Fourth, it would be good to revive the idea of synthetic Eurobonds as collateral instrument for ECB refinancing purposes, built out of portfolios of individual countries' government bonds (e.g. Brunnermeier et al. 2011, Beck et al. 2011), which would per construction limit the exposure of Eurozone banks to their government's debt.

Finally, there is the broader question of the sustainability of large government debts across several Eurozone countries (Eichengreen and Panizza 2016), an issue beyond the financial sector and requiring a political solution.

Completing the banking union

As much as the current banking union structure is beyond even the most ambitious dreams of economists in 2008/9, several important elements of a fully functioning banking union have been missed, including a purely supra-national European bank resolution and a proper funding mechanism. The bank resolution mechanism is still a mix of national and Eurozone-wide decision processes, especially when funding decisions are involved. This can be clearly seen in practice in recent controversies about bank resolutions in Italy and Portugal; another sign that national governments and national banking systems are still closely linked. In addition, the funding still seems somewhat limited. While De Groen and Gros (2015) compute that the targeted fund might have been enough to solve the failures during the Global and Eurozone crises, it seems rather on the limited side. Most importantly, a public backstop is missing, even though first attempts at possible liquidity extension to the Resolution Fund during crisis times are being discussed. The ECB would have to play a significant role in such a public backstop mechanism (either directly or indirectly by serving as backstop to, for example, the ESM). The fact that the ECB is being pushed indirectly into such a role, by taking on a greater and greater role in crisis management beyond monetary policy, under the headline 'whatever it takes', is rather ironic and politically counter-productive. Finally, plans for linking the deposit insurance schemes across the Eurozone are important to provide the necessary certainty that the safety of deposits does not depend on the solvency position of national governments.

A second issue is the creation of a truly European banking system. This does not imply the absence of local banks; it rather implies cutting the unhealthy entrenched relationships between dominating local banks, supervisors and politicians. Such links can be seen across the Eurozone – from politically motivated recapitalisation decisions for German savings banks (Behn et al. 2014) and close connections between *cajas* and local politicians in Spain (Garicano 2012) to the Greek government recently leaning on a large Greek bank to fire its CEO. There is no immediate solution to this problem and it will never be solved completely. The supervision of the systemically most important banks in the Eurozone is an important step.

One important issue is the regulatory perimeter. The brief of the SSM seems to be limited to regulated banks and cannot be easily – i.e. without further European-level legislation – be extended to bank-like or non-bank financial institutions seen as systemically important. This puts the regulator at a disadvantage as financial intermediaries shift risk towards outside of the regulatory perimeter. Second, what is the role of the SSM in macro-prudential regulation and its relationship with the ESRB (which covers the whole European Union and not just SSM members)? While the SSM can use macro-prudential tool covered under the CRR and CRD IV, it cannot use other macro-prudential tools, which will remain exclusively under national authority (Sapir 2014). Given that not only micro- but also macro-prudential decisions have externalities beyond national borders, this seems another gap in the banking union. The ESRB, which does not have any formal powers beyond issuing warnings and recommendations, cannot completely fill this gap.

Finally, what is the relationship with non-Eurozone countries, both those that will join the SSM and those that will not? The critical difference for non-Eurozone members of the SSM would be an asymmetry in their financial safety net, with lender of last resort and resolution funding strictly on the national level, although solutions such as access to liquidity lines might be considered (Zettelmeyer et al. 2012). Cooperation with the Bank of England, which will stay out of the SSM for the near future will be critical, given the importance of London as financial centre. Ultimately, tailor-made solutions are necessary for arrangements with European countries outside the Eurozone (Beck and Wagner 2016).

By reducing banking nationalism within the EU, carefully designed regulatory reforms in banking can thus also contribute to the recently advocated Capital Markets Union. Ultimately, however, the banking union will not be able to stand alone without further integration along other policy dimensions, most prominently fiscal policy. From an optimistic viewpoint, banking union might open the door to such reforms; from a pessimistic viewpoint, further reforms might be prevented by the lack of a fiscal union.

Aiming for institutional convergence

Analysts of the Eurozone often point to the risk sharing elements within the US – another large currency union with divergent sub-national economies – as comparison point for the Eurozone. One important element in the US are integrated financial markets. It is more: there is strong empirical evidence that the banking market integration in the 1970s and 80s in the US led to higher consumption smoothing and risk sharing across US states (Acharya et al. 2011). Capital markets in the US have been integrated for a longer time, given the common contractual and governance tradition and framework.

A Single European Market in Banking as well as a Capital Market Union rely on convergence in the underlying contractual and informational institutions. A lot of progress has been made in the regulatory area for the banking system within the Eurozone (in the form of the above discussed banking union). Plans to create a Eurozone-wide credit registry are under way and will also help both for stability and competition purposes. Other plans for strengthening regulatory institutions and clearing systems are very welcome to foster the integration of capital markets across Europe and help the development of other non-bank components of the financial system. The necessary institution building for integrated capital markets, on the other hand, is more difficult to undertake, given that legal codes, including contract and insolvency laws, are historically grown and entrenched. Similarly, the institutions to apply and execute these laws (courts, registries, legal profession etc.) have developed over generations and centuries. A convergence process in the legal framework is thus a much longer-term process than regulatory convergence. However, it is never too early to start on this.

Political constraints

One major obstacle is the diverging interests of Eurozone members and non-Eurozone members of the EU. Some of the above initiatives, such as the Capital Market Union, are on the EU rather than Eurozone level. The cost-benefit calculus of undertaking deep institutional reforms, however, is a different one for the Eurozone and non-Eurozone members. The question will therefore be whether further integration has to be limited to the Eurozone resulting in an integration process of two speeds. From the viewpoint of the Eurozone, there is the trade-off between maximising integration to maximise the survival chances of the Euro versus minimising the risk of losing the rest of the EU.

A second major risk is that reform fatigue within the EU and the Eurozone has been replaced with outright antagonism against any further integration and even attempts to regain national sovereignty. The current refugee crisis and resulting controversy about the Schengen zone (seemingly completely unrelated to anything discussed above) can have very negative spill-over effects in this context. These are not easy times for attempts to strengthen the Eurozone further!

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The EZ Crisis: What went wrong with the European financial integration?

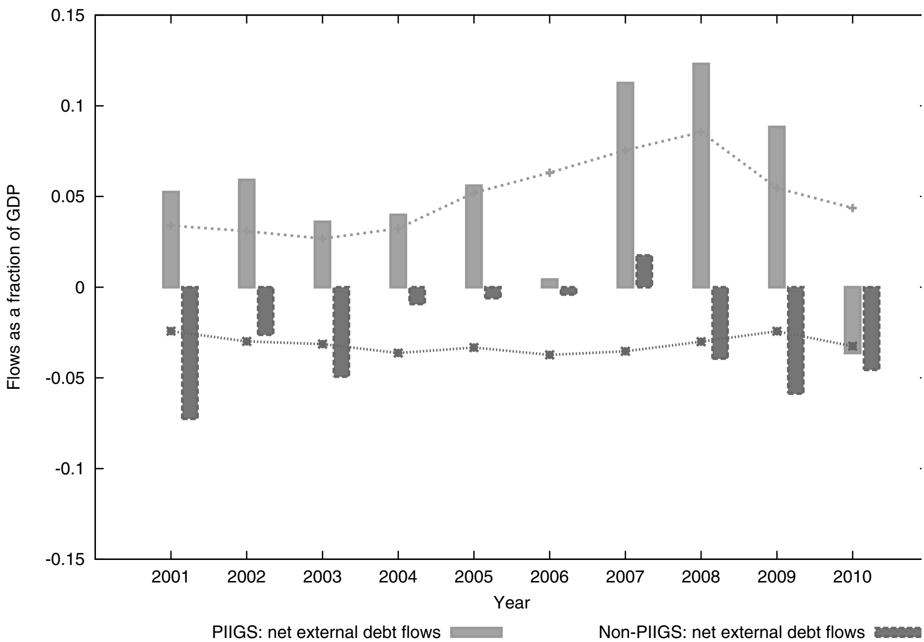
Sebnem Kalemli-Ozcan
University of Maryland and CEPR

The ongoing Eurozone Crisis has raised many debates on what needs to be done to reduce the frequency and severity of similar future crises. This column discusses the implications of equity versus debt flows in terms of risk sharing during the Crisis, and in terms of slow recovery in the aftermath of the Crisis. The author suggests that to induce a fast recovery in an aftermath of a crisis, the EZ needs a banking union and a broader financial union based on equity ownership.

The EZ Crisis that has been ongoing since 2009 forced policymakers and academics to think hard about what more needs to be done to reduce frequency of future EZ crises and to reduce severity when they do occur. As has been argued in the 'Consensus Narrative' essay, the EZ Crisis was a sudden stop crisis that constitutes a dry up in external financing provided by capital flows for several countries. To be able to formulate meaningful solutions for potential future crises, first and foremost, we have to understand the importance of differences in types of capital flows that funded the intra-EZ imbalances.

Figure 1 plots net capital inflows together with net external debt, both as fractions of GDP. Figure 1 shows that most of the capital inflows were debt flows during the first decade of the euro, especially for the periphery countries (denoted with P), whereas non-periphery countries (non-P) were mainly net lenders of such debt (see Kalemli-Ozcan et al. 2014). These financial intermediation patterns within the EZ were shown elsewhere and discussed extensively, but the implications of equity versus debt flows in terms of risk sharing during the Crisis and in terms of slow recovery in the aftermath of the Crisis have been overlooked. I would like to focus on these issues in this essay.

Figure 1 Net capital inflows and net external debt in EZ



Risk sharing benefits

If the main form of financial integration is in terms of cross-border debt flows, such flows have no risk sharing benefits during a severe financial crisis. To obtain risk sharing benefits, the financial integration should involve cross-border ownership of assets, that is foreign investment in the form of equity ownership such as foreign direct investment (FDI) and portfolio equity flows. The difference between FDI and portfolio equity investment is the amount of ownership of capital. Capital ownership exceeding more than 10% is classified as FDI, and ownership of capital that amounts to less than this amount as portfolio equity investment (according to standard balance of payments accounting).[1] Both with FDI and portfolio equity investment, foreign equity investors share the risk when the stock market plummets and companies lay off workers since profits of the businesses go down. If such investment is limited, then risk sharing will depend on government and private savings. The problem then is that governments cannot provide risk sharing in the middle of a severe crisis unless they had saved in advance, leaving the burden of risk sharing during a crisis to private savings. This implies a rapidly declining consumption and a deepening recession.

Savings and consumption fluctuations

One can measure how much of the output risk is shared in terms of accounting the fluctuations in consumption as a function of fluctuations in GDP; that is for every 1 euro fall in GDP, how much consumption falls, and vice versa.[2] If we focus on periphery countries during 1999-2009, such risk sharing via capital markets (that is cross-border ownership of EZ assets) only amounts to 10%, and for the non-periphery countries to 12%. This means 10-12% of the shocks to GDP are smoothed out via cross-border asset ownership within the EZ and hence not reflected in changes in consumption. Rest of the shocks to GDP is either smoothed ex-post via savings or not smoothed at all, directly affecting consumption. Such ex-ante smoothing via financial markets in the US, among the US states, is 50%. Notice that there is no role for government transfers in such consumption smoothing, where it is purely achieved via integrated financial markets.

When we measure how much savings help to smooth out GDP fluctuations during the first decade of the euro, we see that for periphery countries it is 30%, and for non-periphery countries it is 35%. This means that a big portion of GDP fluctuations, 55% in non-periphery and almost 60% in periphery countries, were not smoothed out. If we further divide the smoothing role of savings between government and private savings,

1 100% ownership, that is greenfield FDI, is rare. Most FDI (over 90%) takes the form of mergers and acquisitions in Europe, and among the advanced countries in general, see Navaretti and Venables (2008).
2 This methodology is first developed by Cochrane (1991), and Asdurubali et al. (1996) for the US, and applied to Europe by Kalemli-Ozcan et al. (2003).

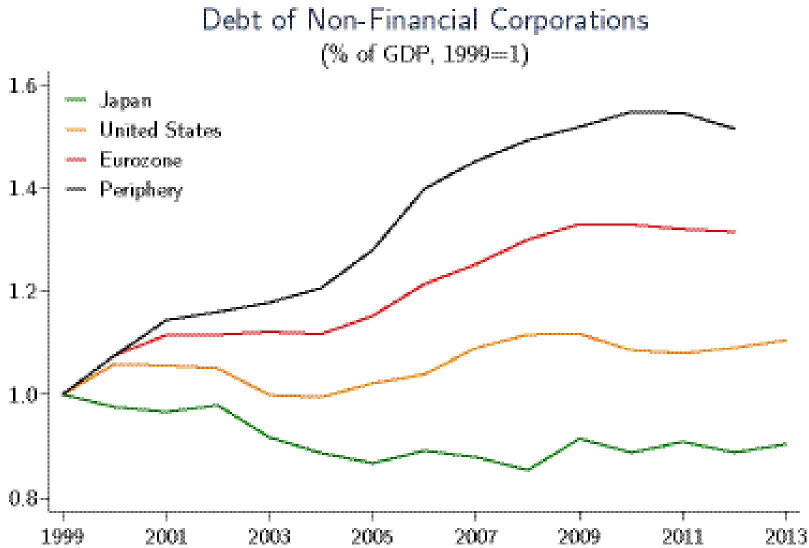
we see that it was half-half; that is half of the amount smoothed by savings is due to government savings and other half is due to private savings in both set of countries. It is not hard to see then what will happen when all governments were forced to save in the middle of the Crisis after 2009. Risk sharing collapses completely, where unsmoothed part of GDP fluctuations comes close to 100%; leaving private saving to carry the entire burden and to the extent that private savings cannot do the job, consumption collapses with falling GDP.

Increasing equity market integration

It is essential that policymakers aim to increase equity market integration within the EZ which will reduce the severity of the crises substantially when they happen and might also reduce their frequency since financial market segmentation will decrease as a result of equity market integration. In addition, if financial integration is in the form of too much debt and too little equity, there is a big problem in terms of sluggish and prolonged recovery as we had observed before during the debt crises of emerging markets and have been observing for the EZ area since 2010.[3] As shown in Figure 2 the Eurozone, especially the periphery countries, had accumulated too much corporate debt relative to firms in the US and Japan.[4] A natural consequence of such accumulation is increasing levels of corporate debt overhang, measured as debt to earnings ratio of corporates plotted in Figure 3. Such corporate debt overhang is one of the key reasons for sluggish investment and slow recovery in the EZ as shown in Figure 4, where net investment by high and low debt overhang firms plotted separately. The difference between the collapse in investment during the Crisis and the divergence in investment rates in the aftermath of the Crisis at the end of the sample is clearly visible.

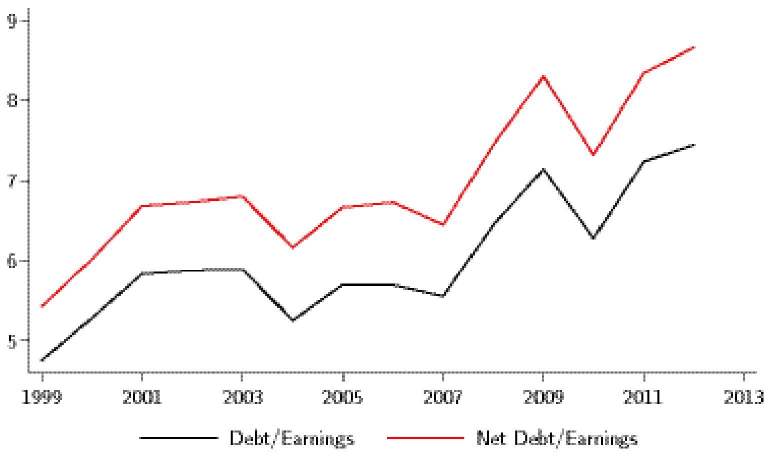
3 See Reinhart and Rogoff (2009).
4 Figures 2,3,4 are taken from Kalemli-Ozcan et al. (2015).

Figure 2 Corporate debt in Europe versus US and Japan



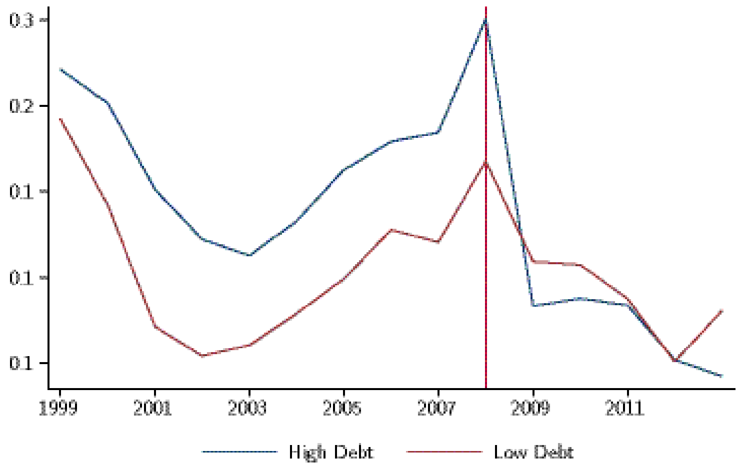
Sources: Organisation for Economic Co-operation and Development, and World Bank Organization.

Figure 3 Corporate debt overhang in EZ (Aggregated from firm-level data)



Note: Unbalanced sample of all firms in our dataset.

Figure 4 Corporate investment by debt level in EZ



Source: Unbanlanced sample of all firms in our databases.

Why limited degree of equity investment in the EZ

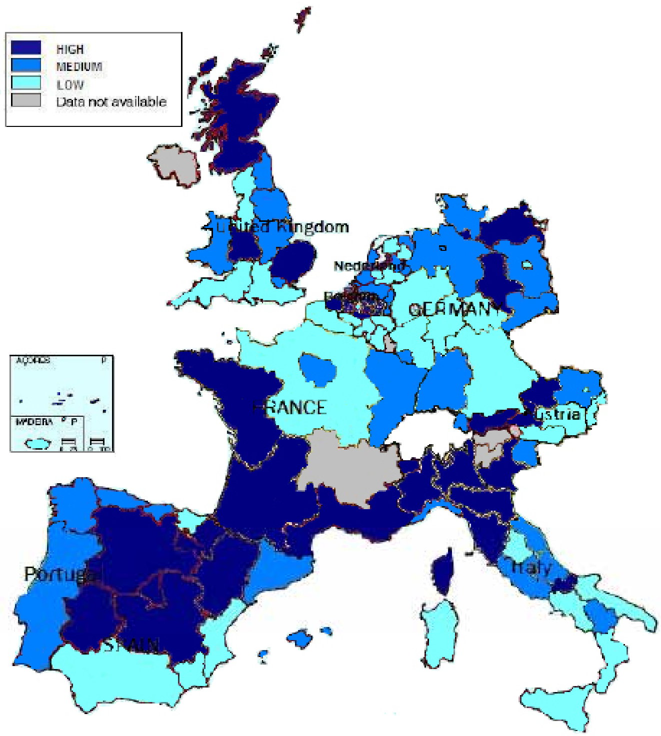
What are the reasons behind the limited degree of equity investment financial integration in the EZ? The ongoing research shows that there are two key elements that hinder equity integration in the EZ.

- First one is cultural that is 'trust'.

As shown in Figure 5, there is great deal of heterogeneity in terms of trust within Europe. What is plotted in Figure 5 is a typical measure of trust as measured by World Value Surveys as individual responses to questions such as: 'most people can be trusted', 'ECB can be trusted', and so forth. Research shows that ownership of capital within the EZ is less than fully diversified even within countries or regions sharing the same country-level institutions. Regions of a country where their residents have low levels of trust will also have lower degrees of financial integration.[5]

5 See Ekinci et al. (2007).

Figure 5 Trust within EU



- The second reason for the low levels of equity market integration within the EZ is the fragmentation in laws and regulations.

Such fragmentation leads to segmented financial markets. A significant ongoing effort on banking union will certainly help in mending such segmented markets but as we know such a banking union is only the first step in achieving full-fledge financial integration. Banking union itself is not a panacea in terms of reducing the frequency of crises and their severity in terms of crises' effect on output. Banking union can easily make output cycles divergent depending on the source of the shock to the economy. If the shock is a common shock to all banks in the EZ then they all cut lending and lead to a credit supply driven fall in GDP in all countries. If the shock is idiosyncratic in terms of a single country banking system, under a banking union, this can be smoothed out. However, if the shock is idiosyncratic in terms of a single country's firms and households (a real shock instead of a financial shock), then all the union banks will stop lending in that country and lend in the other more productive countries leading to a credit supply driven divergence in output cycles.

Divergence in output growth is not an issue if consumption growth converges among the EZ countries, which in turn, again, can be achieved only with full financial integration based on equity flows that is cross-border asset ownership. If we track the patterns of foreign asset ownership in European countries using a harmonised bilateral firm-level dataset during 1999–2012, we observe the amount of foreign investment into each firm over time together with the identity of direct and ultimate investors.[6] Such an investigation reveals that the majority of equity investment in Europe comes from other European countries. However, a much larger share of ultimate foreign ownership of European firms are from north America and Asia, reflecting that such investors invest in European firms indirectly, through European financial centres. The ultimate foreign investors prefer to invest in countries with similar regulatory frameworks to theirs, highlighting the fact that ultimate risk bearers prefer non-segmented legal infrastructures.

Concluding remarks

Without a harmonised legal infrastructure, both equity integration and banking union will suffer from legal complications moving forward as happened during the first 10 years of the euro. Financial Services Action Plan (FSAP) across EU countries was launched in 1999 and included 42 measures aimed at creating a harmonised EU market for banking, securities, and insurance. The most important part of the project consisted of 27 EU-level directives and two regulations. While regulations become enforceable immediately across the EU, the directives are legislative acts that require from member states to achieve some well-specified results without clearly dictating the means. Most importantly, EU countries have some discretion in the timing of the adoption

6 Kalemli-Ozcan, Sorensen, Villegas-Sanchez, Volosovych, 2015, "Who Owns Europe's firms?," working paper.

(transposition) of the directives into the domestic legal order. European governments usually delayed the transposition of the directives to national law for various reasons such as shielding local firms from competition and protecting domestic interests. Hence, the transposition of the directives took several years and differed considerably across the continent.

An alternative is, of course, a fiscal union, where government transfers will do the job of smoothing consumption during severe financial crises if all governments were not in trouble at the same time. A banking union and a broader financial union based on equity ownership are both easier to achieve politically than a fiscal union and will induce a faster recovery in the aftermath of the crisis compared to a fiscal union combined with financial integration based on debt flows.

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Part 3

Focusing on fiscal and monetary policy

Building common fiscal policy in the Eurozone

Guido Tabellini[1]
Università Bocconi, CES-Ifo, CIFAR and CEPR

In order to preserve financial integration and stability, the Eurozone needs to build elements of a common fiscal policy. This column discusses how this could be done. It proposes the creation of a European Fiscal Institute, modelled on principles similar to those used for the ECB. Such an establishment would require treaty and constitutional reforms in member states, which would not be politically feasible in the short term.

One of the main lessons of the Global Crisis is that to preserve full financial integration and financial stability the Eurozone needs to build elements of a common fiscal policy (see Obstfeld 2013 and Tabellini 2015 and the Five Presidents' Report, European Commission 2015). In this column I discuss the principles and priorities of how this could be done.

Realising such a deep transformation would require Treaty changes and constitutional reforms in member states, something that does not appear politically feasible in the near term. Yet, at some point the Eurozone will have to grapple with these issues, and the more thoroughly they are discussed, the sooner they will fill the political agenda. Of course, a large literature already exists on this topic. In what follows, I draw in particular on Ubide (2015) and Sapir and Wolf (2015) – also see Corsetti el al (2015) and Paris and Wyplosz (2014).

1 I thank Massimo Bordignon for helpful comments.

1. Priorities

Unlike for the US and other federations that achieved integration at an early stage of state development, all Eurozone countries already have large (arguably too large) government spending and taxation. Under any foreseeable scenario, most of these government functions and capacities will have to remain national. The fiscal union should have a few main purposes and priorities, namely to complement the monetary union in two main ways.

- By providing an arrangement that allows fiscal stabilisation at the level of the Eurozone as a whole.
- By providing resources to withstand systemic financial crisis (banking crisis and sovereign debt crisis).

The first point was emphasised also in the Five Presidents' Report. The Eurozone needs a policy tool with which to manage aggregate demand and stabilisation policies during large Eurozone recessions. European monetary policy should bear the primary responsibility for cyclical stabilisation during normal times. But in exceptional circumstances, monetary policy alone becomes over-burdened and is constrained by the zero lower bound on nominal interest rates. A major lesson of the Global Crisis is that, in such circumstances, monetary policy should be coordinated with fiscal policy to sustain aggregate demand. Given current deflationary trends, it is quite possible that the zero-bound on interest rates will be a recurrent threat during recessions for years to come. If so, the lack of an aggregate fiscal policy tool will be a major handicap for the Eurozone. A primary goal of the fiscal union should be to remove this handicap. Of course, the common fiscal policy tool should aim at the Eurozone average and only in exceptional circumstances, leaving idiosyncratic national shocks to be dealt with by member states.

The second point is instead much more controversial. The Five Presidents' Report explicitly rules it out, with the argument that the ESM already performs this function.

The ESM arrangement is certainly a very important step forward, but it is doubtful whether its current structure is adequate to prevent the risk of sudden stops. First, its resources (a maximum lending capacity of 500 billion, about 5% of Eurozone GDP) may be insufficient to deal with large systemic crisis - in many European countries bank assets are several multiples of GDP.

Second, the decision to provide stability support to an ESM member is taken by unanimity and requires prior approval by some national Parliaments.

This makes it highly uncertain and open ended whether and how the ESM resources would actually be available.

For these reasons, the risk of euro exit and of sudden stops remains a significant concern. To be viable in the long run, the monetary union needs an effective system of risk sharing in exceptional circumstances, such as sudden stops and systemic financial crisis (see Obstfeld 2013). Conditioning such an arrangement on the approval of national political majorities vastly reduces its effectiveness, both ex-ante and in the case of need.

In a recent interesting contribution, Gros and Belke (2015) argue that risk sharing through a well-functioning banking union and capital market union may be sufficient to absorb losses from most financial crises, without the need of a fiscal union, provided that the a common system of deposit re-insurance is in place. A discussion of this issue goes beyond the goal of this article, but I note the following.

- First, current arrangements limit the resources needed from the newly constituted Single Resolution Fund in the event of a banking crisis, because they impose very demanding bail-in requirements on bank creditors.

This increases the risk of contagion and domino effects, and may not be a viable solution in the event of systemic banking crises.

- Second, a truly transnational banking union is unlikely to emerge in Europe even in the long run, if the risk of Euro exit and of sudden stops remains significant.

In the presence of this risk, banks will retain a large home bias even if under common (rather than national) supervision.

A comparison with the US, where state debt is negligible and a fiscal union already exists, is misleading. A fiscal union is a pre-requisite for a well- functioning capital market and banking union. Although it may be true that, once credible elements of a fiscal union are in place, the banking system could evolve so that most of the risk would be shared by financial markets and the losses born in the private sector, rather than by tax-payers.

The two points deliberately do not include another controversial issue, namely whether a fiscal union should also perform some of the risk sharing functions towards individuals that are currently performed by national governments. I think this would be a mistake, at least at the current stage. Risk sharing between countries is required in a monetary union, but should mainly be limited to exceptional circumstances, such as sudden stops and systemic financial crisis, or very large shocks. A European system of unemployment insurance (or other welfare programmes directly insuring individual risks) may be politically or symbolically attractive, but would entail great difficulties.

To avoid moral hazard and permanent transfers between countries, a common system of unemployment insurance would require strict harmonisation of national labour market institutions, which is difficult and perhaps undesirable. Such a system would also have small economic benefits, for two reasons. First, all members states already have the capacity to directly insure their own citizens. Second, if countries do not lose market access, they should be able to self-insure against small shocks and business cycle fluctuations. What is most important is to insure against large shocks or events that could entail the loss of market access or threats to financial stability. It is in such circumstances that individual member states are powerless, and that systemic externalities are most threatening.

An implication of the foregoing remarks is that the Eurozone does not need to build a large tax capacity of its own. What it needs is the ability to enforce the collection of transfers from member states, not necessarily in very large amounts at once, but for possibly very long periods of time. This would enable the Eurozone to issue its own debt at times of crisis, or for fiscal stabilisation purposes. As in the proposals by Ubide (2015) and Corsetti et al (2015), this debt would be backed by specific tax revenue collected by member states, but earmarked to service Eurozone debt.

According to Corsetti et al (2015), member states would pledge specific sources of future revenue (such as seigniorage, or a fraction of the VAT, or the proceeds from a recurring wealth tax) for say 50 years. The Eurozone could then issue 'stability bonds' backed by these future sources of revenue. The proceeds of the stability bonds would then be used to retire national debt from circulation, until all national public debts have reached 60% of GDP in all member states. The main goal of the proposal is to reduce the fragility of the Eurozone by getting rid of the legacy of high public debts. Since the current stock of national debt differs between countries, the stability bonds would be backed in greater proportion by pledges from the currently highly indebted countries that need to retire larger amounts of their debt. This is a drawback of the arrangement, which could undermine the rating of the stability bonds.

Ubide (2015) proposes a similar scheme, except that pledges of future revenues would be the same proportion of GDP for all member states, and the stability bonds would primarily be used for fiscal stabilisation and risk sharing in exceptional circumstances, rather than for national debt reduction. He envisages capping the Stability bonds at 25% of Eurozone GDP. Below I discuss more in detail how this arrangement could work. Like in Ubide (2015), debt would be backed by the same GDP percentage of revenue from all member states, and it would be used mainly as an instrument of aggregate demand or crisis management.

In this perspective, the Eurozone would exploit its key prerogative of being a super-national institution. In pledging and earmarking specific future sources of revenues to the Eurozone in predetermined amounts, member states would accept an irreversible transfer of sovereignty over those revenues. On their own, member states would not have the commitment capacity to credibly earmark future sources of revenue for, say, a sinking fund designed to retire outstanding public debt, or to back a senior debt instrument in times of emergency. An international agreement (with the associated autarky costs of unilaterally breaking the agreement) would provide this commitment capacity. Such an arrangement would give the Eurozone the ability to access financial markets in favourable terms, without necessarily having developed its own tax capacity.

2. Governance

Achieving a common fiscal policy means first of all having a Eurozone policymaker in charge, say a European Fiscal Institute (EFI) to adapt the name from the precursor of the ECB. Coordination of national fiscal policies will not do because enforcement of coordination is inevitably imperfect, and policy needs to be guided by a EZ perspective rather than by national interests.

The EFI could be the logical evolution of the ESM, as it acquires new functions and additional resources, and as it adapts its governance structure to the new greater responsibilities. Sapir and Wolf (2015) have suggested modelling the Fiscal Institute on principles similar to those used for the ECB, clearly a well-functioning European institution.[2] The key governing body is the Eurogroup (i.e. a council of national economic and finance ministers that already acts as the Board of Governors of the ESM) plus a smaller executive committee with agenda setting powers and consisting of appointed individuals. The Chairman of the Institute is also the chairman of the executive committee, like the ECB President, and would resemble a Eurozone treasury minister. Most decisions are by simple or qualified majority, depending on the subject matter, with executive committee members having considerable weights.

2 Sapir and Wolf (2015) call it the Eurosystem of Fiscal Policy (EFP). In their proposal, the EFP could impose specific targets (for fiscal deficit or surplus) to all member states, with the aim of achieving an appropriate fiscal stance in the Eurozone as a whole. This would be less effective than a fiscal stabilisation achieved through Stability bonds, however, since the fiscal expansion (or contraction) would only occur in some countries and not necessarily in the countries that need it most. Guiso and Morelli (2014) suggest the creation of a European Federal Institute, but they are less specific about institutional details, and they don't discuss Eurozone debt.

The key innovation here is the abandonment of unanimity in most decisions. This is inevitable, because if national vetoes can block the implementation of a common policy, then the Fiscal Institute would not be very different from the Eurogroup, and we have already seen the difficulties of this body in reacting to the Global Crisis. This poses the challenge of how to give democratic legitimacy to the common fiscal policy – unlike monetary policy, fiscal policy also concerns redistribution and cannot be guided exclusively by efficiency criteria. The obvious answer is to involve the European Parliament; all major policy decisions of the Fiscal Institute also have to be approved by an ad hoc committee of the European Parliament, or by the European Parliament itself, restricted to Eurozone representatives.

3. Stability bonds

The main responsibility of the European Fiscal Institute would be to manage a debt instrument of the Eurozone (following Ubide 2015 and Corsetti et al 2015, call it stability bonds), backed by a Eurozone tax capacity. Here is how this could be done.

All EZ member states agree to transfer to the Institute a given amount of their yearly tax revenue (expressed as a percentage of their GDP), upon request by the Institute, up to a pre-established ceiling and up to a pre-determined future date.

The transfer has to be the same percentage for all member states, to avoid redistribution between countries. This would provide the back bones of a Eurozone fiscal capacity with which to service the stability bonds over time. To achieve a high rating on the Stability bonds, member states would also have to give the EFI authority to request at any time an extraordinary transfer of revenues to meet unexpected debt service needs (Ubide 2015).

At the time of issue, the overall amount of Stability Bonds cannot exceed a predetermined percentage of aggregate GDP, say 25% of GDP as in Ubide (2015).

Of course, the Institute's debt ceiling and the ceiling on the pre-committed national funds would have to be mutually consistent. These ceilings could only be changed under unanimity rule. Ubide (2015) and Corsetti et al (2015) provide different numerical hypothesis and also include a discussion of which sources of government revenue (including seigniorage from the ECB) could be most easily pledged.

To achieve liquidity of the new debt instrument, the EFI would start by gradually issuing a minimum amount of Stability bonds (until it has reached up to say 10% of aggregate GDP). The proceeds from the Stability Bonds would be returned to member states, who would have to retire their own national debt.

The main purpose of the Stability bonds, however, would be to give the Eurozone a new instrument for intertemporal aggregate demand management without relying on fiscal policy coordination. Thus during deep Eurozone recessions, the EFI would issue additional amounts of Stability bonds and give the proceeds to member states (also in proportion to national GDP), who would be free to use them as they deem appropriate. In particular, the debt proceeds from the Stability bonds could be used to enact a counter-cyclical fiscal policy in the Euro area, if necessary in coordination with monetary policy (including so as to replicate the economic effects of "helicopter money", as suggested by Turner 2015). To achieve some risk sharing between countries against idiosyncratic cyclical fluctuations, debt proceeds could be distributed according to projected or trend GDPs, while transfers would be collected in proportion to actual GDP.

Similarly, in the event of major systemic financial crisis or sudden stops, the EFI could use the debt proceeds (or part of the yearly transfer from member states) to restore financial stability by lending to member states who have lost market access, under strict conditionality, or to supplement national deposit insurance or to directly recapitalise insolvent financial institutions. In this, the EFI would undertake some of the roles currently attributed to the ESM, which would cease to exist and would merge its procedures and activities in the EFI.

Once the outstanding stock of Stability bonds is sufficiently large to be liquid, the EFI would manage it so as to avoid excessive debt accumulation. Thus, in normal times the transfers from member states would be used to retire the Stability bonds that were issued during previous large recessions (or no new transfers would be collected, if the stock of outstanding debt is deemed appropriate).

This arrangement would have several benefits. The Eurozone would acquire a fiscal policy tool with which to stabilise aggregate demand or to grant emergency lending. Over time the public debt composition in the Eurozone would also become more efficient. The stability bonds would be relatively safe, because they would be senior to national bonds, would circulate in relatively small quantities, be backed by a pool of revenues from several member states, and be managed by a technical body less easily captured by domestic political uncertainties. They could be used by the ECB for QE and by domestic banks to diversify their portfolio, reducing the risk of the bank-sovereign 'doom loop' that was at work during the Crisis. At the same time, national debts would become smaller in size (although by only a small amount). Finally, the stronger enforcement capacity of the EFI compared to current arrangements would give more credibility to the goal of debt reduction in the highly indebted countries, and would more easily prevent new accumulation of national public debts (more on this below).

One drawback of this arrangement is the following. In normal circumstances the stability bonds would be serviced by drawing on transfers from member states up to a pre-determined percentage of GDP. This would probably not be enough to achieve a high credit rating, however. For instance, suppose that a member state defaulted on its obligations because it left the EU. In such extreme circumstances, the predetermined transfers by the remaining member states could be insufficient to service the Stability bonds. Alternatively, major economic and financial shocks could have similar implications, even if no member states was in default. Hence, to achieve a high credit rating, the EFI should also have the authority to request exceptional transfers in excess of the predetermined amount, if this was motivated by exceptional debt service needs, and according to pre-specified procedures.

This more open ended commitment of resources to back Eurozone debt should be accompanied with a greater ability of the EFI to interfere with national budgetary policy, as described below.

4. Supervision of national debt policies

Besides managing the common fiscal policy, the European Fiscal Institute would also assume the role currently performed by the European Commission together with the European Council of enforcer of fiscal discipline in member states. With the stronger risk sharing capabilities discussed above, moral hazard would be an even bigger concern than under current arrangements. Moreover, care must be taken to avoid the danger that stability bonds would pile up on unsustainable national debts, rather than leading to an overall debt reduction. Thus, in exchange for the enhanced risk sharing capabilities, member states would have to accept a more intrusive external interference in national fiscal policy.

Specifically, the Fiscal Institute should also have authority to veto national budgets, and impose specific targets for deficits or surpluses, as suggested by Sapir and Wolf (2015). This interference with national political decisions would have to be justified by exceptional circumstances, such as a country being in gross violation of the debt sustainability requirement. The main goal here is to insure adequate fiscal discipline in all member states, but it is also conceivable that the European Fiscal Institute could impose a more lax fiscal policy than approved at the national level, if a fiscal expansion is justified by a major euro-wide recession.

5. Evolution

Over time, the European Fiscal Institute could evolve into a more accomplished fiscal union for the Eurozone. On the one hand, the fiscal union could evolve so as to fund a small set of European public goods such as border patrols, European infrastructures, a European defence system, scientific research.

On the other hand, the revenue collection system could be improved. Rather than relying on transfers from member states, the Institute could be given its own tax bases (or fractions of national tax bases, such as the VAT), on which to levy its own tax rates. This could have symbolic and political benefits, but it would require some centralised tax collection or monitoring capacity, to avoid moral hazard in the enforcement of tax collections. A true EZ tax would also entail the risk of excessive expansion of public spending at the Eurozone level, something to be avoided given the size of national government spending.

6. Concluding remarks

The arrangement described above entails two obvious politically obstacles, that may be difficult to overcome at least in the near term. First, countries have to give up sovereignty over a fraction of their tax revenues.

It is important to stress, however, that the sacrifice needs not be large in terms of size of yearly revenue. Stability bonds don’t need to be a large fraction of aggregate GDP in order to insure adequate fiscal stabilisation or to provide risk sharing during emergencies. What is essential is the long time horizon, the pledge to transfer national revenue to the Eurozone should extend for a long period of time. A pledge over several decades can provide adequate backing, even if the yearly transfer is relatively small, provided that the arrangement is credible and lasting. In other words, setting up a fiscal union along these lines entails an important element of irreversibility. Without the expectation of irreversibility, the pledge would lack credibility and the arrangement would fail. But the expectation of irreversibility is at the core of the single currency, and it is meant to distinguish it from a fixed exchange rate regime.

The second political obstacle is that the benefits of this arrangement may not be perceived as symmetric. The weaker and highly indebted countries are more likely to lose market access or to be involved in a sudden stop. The benefits of stability bonds are likely to be greater for them than for the stronger member states. On the other hand, the arrangement also entails a greater expected loss of sovereignty for the weaker or highly indebted member states who are more likely to incur in the veto of the Fiscal Institute over their national budgets. In other words, there is an implicit exchange; in order to enjoy the potential benefits of this arrangements, the weaker member states have to accept a temporary loss of sovereignty if they don't meet the sustainability requirements established ex-ante. This, of course, is a greater loss of sovereignty than that.

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Rebooting Europe: Closer fiscal cooperation needed

Christopher Pissarides
London School of Economics

There are certain conditions needed to make a common currency across diverse economies a success and the Eurozone is clearly not satisfying them. This column argues that institutions and policies in place six years after the debt crisis have mitigated the risks of another Great Recession. But they have not done enough to alleviate the need for fiscal transfers in the future. We need ever-closer fiscal cooperation, with some caveats.

There are certain conditions needed to make a common currency across diverse economies a success and the Eurozone is clearly not satisfying them (see Frankel 2015, VoxEU 2015). In 1990 it was closer to satisfying them but since then member states have moved further apart from each other. In 2016 the Eurozone is too large to manage from the centre and there is a lot of diversity in the economies of member states to leave the management to the invisible hand of market forces. Whatever action has been taken or is still being considered to ensure that crises of the kind and magnitude of the 2010-12 one are not repeated, there is bound to be many instances in in the future which will require an alternative corrective action to exchange rate adjustment.

Internal migration is one such alternative corrective mechanism. Countries in crisis with high unemployment, which would normally experience a depreciating exchange rate, could instead export labour to the better-performing countries. This clearly is not an acceptable solution in the Eurozone, politically, culturally or economically. Mass migration causes political friction, as we are currently seen with Britain at the forefront, Europeans don't like moving in big numbers, as we are seeing with the high unemployment countries, which are losing some but not much of their workforce, and economically the required mobility is simply too large and too slow to take the place of exchange rate movements, even if the other conditions were met.

Capital investments from the rich to the poor in times of crisis are also not a solution, as we have seen in the debt crisis. Far from increasing investments to the programme countries of the south, northern Europeans withdrew their capital in large numbers, making the crisis worse. Capital controls to stop the counter-productive outflow should be unthinkable in a monetary union – although imposed as an emergency on two occasions, in Cyprus and Greece.

The Troika's favourite solution, strongly supported by Germany and some others, is internal depreciation. But it has been a dismal failure in Greece and elsewhere. Greece is the country that has fulfilled the requirement to implement internal devaluation. Unit labour costs and real average earnings fell by 20%. Prices fell by much less, partly because of imported intermediate and final goods which have fixed prices in euros and partly because of domestic monopolies. The result was the wished-for rise in competitiveness, with exports rising and imports falling. But with such a big fall in real earnings domestic demand fell by even more. Because domestic demand is much bigger than export demand, the fall in domestic demand completely overwhelmed the rise in exports. The internal depreciation led to a Keynesian negative consumption multiplier, which worsened the recession. Investment did not rise because of poor domestic prospects – and malfunctioning banks – and public investment collapsed because as part of the internal depreciation the Troika imposed also cuts in spending and increases in taxes (in the words of Joseph Stiglitz, in reference to France not Greece, the Eurozone went for negative balanced budget multipliers, instead of stimulating the economy with positive balanced budget multipliers).

A second aspect of internal depreciations is related to the channels through which they can be brought about. Whereas exchange rate adjustments are brought about quickly through news, internal depreciations require wage adjustments that are resisted, unless the alternative is worse for the worker and his union. The only mechanism that can bring about a fall in wage costs in decentralised economies is a big rise in unemployment. So even to implement the policy of internal depreciation, which is supposed to bring the country out of recession, the country has to be shocked by a bigger recession first. This again happened in the programme countries in the Eurozone.

Exchange-rate adjustments within the Eurozone

The logical conclusion is that internal depreciations are not a substitute for real exchange rate adjustments within the Eurozone and actually make the situation worse. In the absence of a market mechanism that can substitute for exchange rate flexibility, the only credible corrective mechanism remaining is fiscal transfers. Small fiscal transfers through the European Stability Mechanism have been effective, although the emphasis is on recapitalising the banks rather than stimulating the economy. The European Investment Bank and European Bank for Reconstruction and Development are doing a good job focusing on investment, but their contributions are too small and move too slowly to act as an effective substitute for exchange rate flexibility.

If the Eurozone is to withstand future shocks governments have to be in a position to persuade their parliaments (and voters) that in times of crisis they might have to transfer large amounts of money to the badly affected countries. In order to make this argument there is need of more fiscal discipline within the Eurozone and closer fiscal supervision, so that any need for fiscal transfers that arises is not the result of misconduct by any members but it is genuinely the result of bad luck or external shock that affect some members more badly than the others. In order to facilitate this transfer and the closer supervision the Eurozone needs closer fiscal union, with Eurobonds and a supervision mechanism that goes beyond the existing one.

The mechanism in place today for fiscal supervision is clearly much better than it was in 2000, thanks to the Fiscal Compact and the much closer watch by bodies such as the

Eurogroup. It is doubtful whether a country could get away with the policies that caused the fiscal imbalances since 2000 without a lot of pressure from its partners to come back in line. But I would support an even stricter formal mechanism, such as a Fiscal Policy Council, without executive powers, modelled on the successful Fiscal Policy Councils in existence, such as the one in Sweden.

Alleviating the need for fiscal transfers

Institutions and policies in place today, six years after the debt crisis, have mitigated the risks of another Great Recession, at the cost of slower rate of economic growth throughout the Eurozone, but they have not done enough to alleviate the need for fiscal transfers in future when new crises arise. In order to reboot the Eurozone there is need for an ever-closer fiscal cooperation, with potentially large transfers permitted and with closer supervision needed in normal times to avoid risks, but preferably without the strict counter-productive conditions of the European Stability Mechanism as in current practice.

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How to reboot the Eurozone and ensure its long-term survival

Paul De Grauwe and Yuemei Ji
London School of Economics and CEPR; University College London

The Eurozone Crisis has abated but the question about the future of the euro remains on the agenda. This column discusses some of the design failure of the Eurozone and their possible solutions. The Eurozone in its current state is not an optimal currency area and is fragile. Ideally, a stabilisation fund and a budgetary union should be set up. Since this is politically unobtainable right now, small steps should be implemented to create some fiscal space at the level of the Eurozone, and to start with a limited programme of debt consolidation.

Despite the fact that the Eurozone Crisis seems to have abated recently, the question of the future of the euro remains on the agenda. How can we make sure that the Eurozone will survive? This is the question we wish to address here.

In order to answer this question it is important to start from the design failures that have been identified by economists (see in particular Baldwin and Giavazzi 2015). We stress two of these here. This will allow us to discuss possible solutions to the two problems.

The Eurozone is not an optimal currency area

- The European monetary union lacks a mechanism that can deal with divergent economic developments (asymmetric shocks) between countries.

These divergent developments often lead to large imbalances, which crystallise in the fact that some countries built up external deficits and other external surpluses.

When these imbalances have to be redressed, it appears that the mechanisms to redress the imbalances in the Eurozone ('internal devaluations') are very costly in terms of growth and employment, leading to social and political upheavals. Countries that have their own currency and that are faced with such imbalances can devalue or revalue their currencies. In a monetary union, countries facing external deficits are forced into intense expenditure reducing policies that inevitably lead to rising unemployment. This problem has been recognised by the economists that pioneered the theory of optimal currency areas (Mundell 1961, McKinnon 1963, Kenen 1969).

Fragility of the sovereign in the Eurozone

As stressed by De Grauwe (2011) this fragility arises from the fact that member countries of the monetary union issue debt in a currency they have no control over. As a result, the governments of these countries can no longer guarantee that the cash will always be available to roll over the government debt. This lack of guarantee provided by Eurozone governments in turn can trigger self-fulfilling liquidity crises (a sudden stop) that can degenerate into solvency problems. When this occurs it leads to a massive outflow of liquidity from the problem countries, making it impossible for the governments of these countries to fund the rollover of their debt at reasonable interest rate.

This dynamics can force countries into a bad equilibrium characterised by increasing interest rates that trigger excessive austerity measures, which in turn lead to a deflationary spiral that aggravates the fiscal crisis.

How to deal with the optimal currency area problem?

The standard response derived from the theory of optimal currency areas is that member countries of a monetary union should do structural reforms so as to make their labour and product markets more flexible. By increasing flexibility through structural reforms the costs of adjustments to asymmetric shocks can be reduced and the Eurozone can become an optimal currency area. This has been a very influential idea and has led Eurozone countries into programmes of structural reforms.

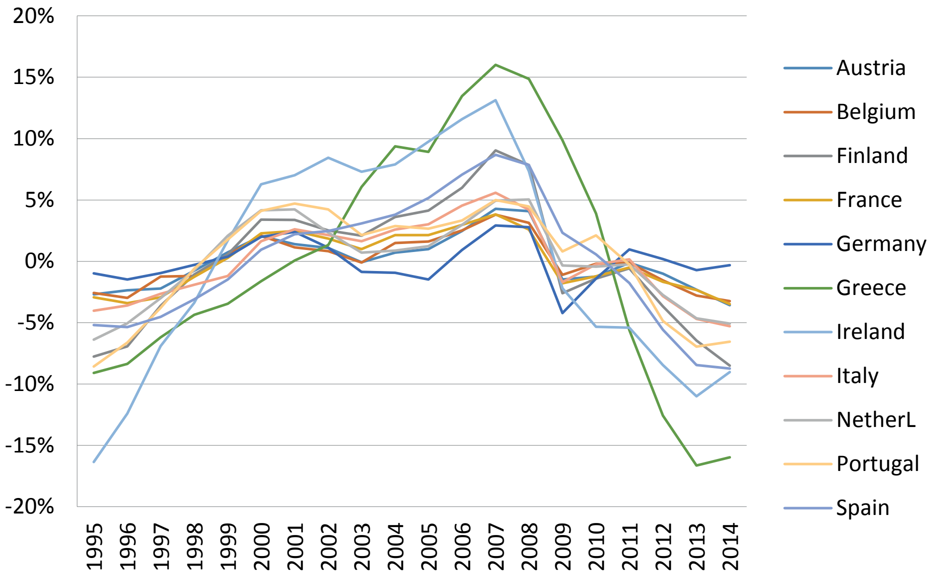
It is often forgotten that although the theoretical arguments in favour of flexibility are strong, the fine print of flexibility is often harsh. It implies wage cuts, less unemployment benefits, lower minimum wages, easier firing. Many people hit by structural reforms resist and turn to parties that promise another way to deal with the problem, including an exit from the Eurozone. From an economic point of view flexibility is the solution. From a social and political point of view flexibility can become a problem. Stressing flexibility as the way out of the conundrum risks creating enemies of the monetary union that as time moves on, will lead to an increasing political momentum favouring an exit from the union.

There is a second reason why the structural reform path should be taken with caution. This is that the nature of the asymmetric shocks has been quite different from the traditional asymmetric shocks analysed in the optimal currency area-literature. In fact business cycles in the Eurozone have been relatively well synchronised. This is shown in Figure 1.

We observe that most Eurozone countries were booming in the period 2000-07 and experienced a downturn since then. If there was asymmetry it was in the amplitudes of the same cycle. Some countries (Ireland, Spain, and Greece) experienced a very strong boom and later a deep and protracted recession. Other countries (Belgium, Germany, France, Italy, and the Netherlands) experienced a much more modest period of booming conditions followed by less intense recessions. Germany stands out as having experienced booms and busts with the lowest amplitude.

Table 1 shows the bilateral correlations of the business cycle components of GDP growth in the Eurozone. It leads to the same observation that the business cycles in the Eurozone were highly synchronised. Again Germany stands out as having the lowest correlation coefficients, although these are still quite high, exceeding 0.5 in most cases (see De Grauwe and Ji 2015b for more detail).

Figure 1 Business cycle component of GDP growth



Source: Eurostat

Note: the business component is obtained by applying a HP-filter to the growth numbers

Table 1 Correlation coefficients of cyclical components of GDP growth (1995-2014)

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Netherl	Port
Austria										
Belgium	0,97									
Finland	0,97	0,98								
France	0,93	0,95	0,97							
Germany	0,69	0,57	0,55	0,59						
Greece	0,73	0,82	0,84	0,74	0,09					
Ireland	0,85	0,89	0,92	0,95	0,41	0,81				
Italy	0,91	0,96	0,98	0,96	0,50	0,86	0,93			
Netherlands	0,93	0,94	0,93	0,91	0,60	0,75	0,86	0,90		
Portugal	0,98	0,89	0,89	0,87	0,37	0,82	0,87	0,90	0,94	
Spain	0,85	0,91	0,94	0,87	0,27	0,97	0,90	0,95	0,86	0,90

Source: Eurostat and authors' own calculation using Hodrick–Prescott filter approach.

If there is asymmetry in the business cycle movements in the Eurozone it is in the amplitude of these cycles. This asymmetry led to a situation in which countries in the group experiencing the highest amplitudes were hit very hard when the recession came, leading to an explosion of government debt. That's when the second problem of the Eurozone stepped in. Markets singled out these countries, leading to massive capital outflows from the first group of countries to the second one. The whole of the Eurozone was destabilised. This problem risks popping up each time the Eurozone is pushed into a recession. Each time some countries will be hit more than others. As a result, large internal capital flows risk further destabilising the system.

- The implications for the governance of the Eurozone from the finding of the overwhelming importance of the cyclical and temporary component of output growth is that efforts at stabilising the business cycle should be strengthened relative to the efforts that have been made to impose structural reforms.

We are not implying that structural reforms are unnecessary, but rather that efforts at creating mechanisms aiming at stabilising the Eurozone business cycles should be strengthened.

Inter-country versus inter-temporal smoothing

There have been many proposals made to create a fiscal space at the Eurozone level in the form of a common unemployment insurance system (see e.g. the Four Presidents report 2012, Enderlein et al. 2012, Beblavy et al. 2015, Alcidi and Thirion 2015).[1] The proposals for such an insurance system have very much been influenced by the standard assumption made in the optimum currency area theory that shocks are asymmetric, i.e. than when one country experiences a recession, and thus increasing unemployment, the other country experiences a boom, and declining unemployment. This facilitates the workings of the common unemployment insurance system. The booming country transfers resources to the country in a recession and thereby smoothens the business

1 There is an older literature making similar proposals. See e.g. Italianer and Vanheukelen(1992), Hammond and von Hagen(1993) and Mélitz and Vori(1993).

cycles in the two countries. Technically and politically such a system encounters relatively few problems.

Problems arise when business cycles are relatively well synchronised but of very different amplitudes in the different member countries. In that case most countries will tend to experience a recession at about the same time, but in some countries the recession will be mild, and in others very intense. This creates both an economic and a political problem. First, countries with a mild recession are asked to transfer resources to countries experiencing a stronger recession. This tends to reduce the intensity of the recession in the latter country at the expense of making it more intense in the former country. It is not clear that this is welfare improving. Second, it is likely to create important political problems in the former country that is asked to transfer resources when the economy is not doing well.

Another way to formulate the previous insights is the following. The traditional proposals for a Eurozone unemployment insurance mechanism are predicated on the view that there is a need to smooth differences in unemployment changes across countries. The insurance mechanism is intended to smoothen these inter-country differences. We have noted however that this is not the typical asymmetry in the Eurozone. Most countries are likely to experience a boom and a recession at about the same time, with different intensities and amplitudes. There is therefore relatively little need for inter-country smoothing of business cycle movements. The more pressing need is to smoothen volatilities over time.

The previous analysis suggests that common unemployment insurance schemes should put emphasis on smoothing over time and not so much on inter-country smoothing. This can be achieved by allowing the common unemployment insurance scheme to accumulate deficits and surpluses over time. The fiscal rule that could be imposed is that the insurance scheme balances over the business cycle.

In principle, inter-temporal smoothing could be done at the national level, by allowing the national budgets to do the job. However, the large differences in the amplitude in the business cycle movements makes such a purely national approach problematic, as it leads to large differences in the budget deficits and debt accumulation between countries. These differences quickly spillover into financial markets when countries that are hit very hard by a downward movement in output are subjected by sudden stops and liquidity crises. This is likely to force them to switch off the automatic stabilisers in their national budgets (De Grauwe and Ji 2015). In addition, these liquidity outflows are inflows in some other countries in the monetary union, typically those that are hit least by the recession.[2] Their economic conditions improve at the expense of the others. Stabilisation of common business shocks with different amplitudes at the national level makes the system unstable.

National stabilisation efforts do not work and introduce an element of instability in a monetary union, mainly because it leaves the countries most hit by the business cycle shocks unable to stabilise. Thus when business cycle shocks dominate it will be necessary to follow a common approach to the stabilisation of the business cycles. This can be provided by a budgetary union. By centralising part of the national budgets into a common budget managed by a common political authority, the different increases in budget deficits following from a (common) recession translate into a budget deficit at the union level. As a result, the destabilising flows of liquidity between countries disappear, and the common budgetary authority can allow the automatic stabilisers in the budget to do their role in smoothing the business cycle. In fact, because a common budget also generates implicit inter-country transfers the countries with the deepest recession will profit from the automatic stabilising features of the common budget most. As a result, a common budget provided the most effective way to stabilise the business cycle.

It is clear, however, that a budgetary union in which a significant part of national taxation and spending is transferred to a European government and parliament is far off.

2 This is confirmed by the empirical work of Furceriand and Zdzienicka (2013) and Hoffmann and Nitschka (2012) who find that during recessions risk sharing through financial markets declines dramatically.

It cannot, therefore, be invoked today to solve the lack of stabilisation at the European level.

In addition, most common insurance mechanisms now being proposed (see Beblavy et al. 2014) have a relatively small inter-temporal smoothing component, amounting to no more than 0.1% to 0.2% of GDP over the business cycle, certainly insufficient to produce a significant inter-temporal smoothing at the EU-level. Fortunately, there are possibilities to enhance stabilisation at the Eurozone level that do not require a full budgetary union.

A proposal: A stabilisation fund

Here is a scheme that can provide some stabilisation at the Eurozone level. A stabilisation fund would be set up. This could in fact be the existing European Stability Mechanism (ESM). During recessions, the ESM would buy national government bonds and issue an equivalent amount of ESM-bonds (Eurobonds) backed by the participating member-countries. During booms the EMS would do the opposite, i.e. buy back the ESM-bonds and sell the national bonds into the bond markets. In doing so, there would be no net accumulation of ESM-bonds over the business cycle.

How does this scheme contribute to stabilisation at the Eurozone level? During recessions national budget deficits increase automatically. Put differently, national governments have to issue new government bonds. We have argued that this process is likely to lead to destabilising capital flows, as some countries' recessions are deeper than others. This leads to more bond issues in the countries hit by the deepest recessions than in the countries experiencing mild recessions. The bond buying operations by the ESM would then tend to support the government bond markets in the Eurozone in general, but at the same time the support would be strongest in the government bond markets of the countries experiencing the deepest recessions. As a result, the EMS-buying operations would tend to unify the government bond markets and would reduce the scope for destabilising capital flows within the Eurozone. This would be a significant achievement.[3]

There are many technical issues to be solved here. In particular, in order to avoid a net accumulation of EMS-bonds over the business cycle, the EMS would only be allowed to buy bonds corresponding to the cyclical component of the government budget. This makes the computation of reliable structural government balances imperative.

How to deal with the fragility problem?

Let us now turn to the question of how to deal with the second problem of the Eurozone, its fragility.

The ECB has a central role to play here. By promising to provide unlimited support in the government bond markets in times of crisis, it can stop liquidity crises that are likely to emerge each time the Eurozone experiences a recession; liquidity crises that destabilise the system leading to large capital outflows from some country to other countries in the same monetary union.

The ECB recognised this problem when it started its OMT-programme in 2012. This certainly helped to pacify financial markets at that time and avoided the collapse of the Eurozone.

The issue arises of how credible the OMT-programme is for future use. The credibility problem arises from the fact that when using the OMT programme the ECB will have to decide whether the crisis it is facing is due to a liquidity or a solvency problem. If it determines it is a liquidity problem it should step in; if it decides it is a solvency problem it should not. In the latter case the other governments should decide whether or not to support the troubled government.

3 The proposed stabilisation fund resembles the proposal made by Drèze and Durré(2012). The Drèze&Durré proposal, however, is a pure inter-country insurance mechanism imposing that the fund balances its books at each moment in time. Note also that the scheme proposed here is very different from the OMT-programme of the ECB that is intended to be used in times of crisis. In addition, OMT is conditional on programmes of austerity and tends to be procyclical.

This creates huge political problems that the ECB cannot take on. It is generally very different to determine whether the problem is due to lack of liquidity or to insolvency. The difficulty to be sure makes it difficult for the ECB to step in without creating political controversy. In the latest Greek crisis the ECB decided that the Greek problem was one of insolvency of the Greek government and therefore it refused to support the Greek government bond market, precipitating the crisis and leading to intense political conflicts in the Eurozone.

All this will lead to doubts about the willingness of the ECB to provide liquidity to future governments in times of crisis. As a result, the credibility of OMT is limited, which means that it is not an insurance mechanism that will stabilise the markets in future crises.

This problem does not exist in standalone countries. The commitment of the central bank to support the sovereign of a standalone country in times of crises is unconditional. As a result, its credibility is 100%. This may come at a price though, because it also implies that the credibility of the central banks' commitment to price stability is less than 100%. Paradoxically, one may argue that the commitment of the ECB towards price stability is stronger than in standalone countries precisely because the commitment of the ECB towards the support of the 19 different national governments is weak.

The only way to solve the lack of credibility of the ECB as lender of last resort in the government bond market is by creating a budgetary union that includes the consolidation of a significant part of the national debts. Such a consolidation mimics the relation between the central bank and the government that exists in standalone countries. It makes the credibility of liquidity support of the sovereign watertight and eliminates the danger of destabilising capital flows within the union. Clearly such a consolidation can only occur if it is embedded in a political union, characterised by a central government that has the power to tax and to spend.

Conclusion

We have identified the conditions under which the Eurozone's fragility can be eliminated making it possible for the monetary union to survive. But these conditions are politically very intrusive, requiring a very large transfer of sovereignty from nation states to a central Eurozone authority. The conclusion can only be that this is politically impossible today.

History teaches us that what one considers politically impossible at one moment of time can quickly change and become possible when conditions become extreme. Nevertheless, today a political union such as the one we have spelled out appears for most of us to be out of reach.

There are two possible reactions to this situation. One is to despair and to conclude that it would be better to dissolve the monetary union. It will never work anyway. The other reaction is to say, yes it will be very difficult, and the chances of success are slim, but let's try anyway. That is the position we are taking.

If one takes this attitude one quickly comes to the conclusion that success can only occur by following a strategy of small steps. A revolutionary approach will simply not work.

What are these small steps?

We see essentially two.

- One is to create some fiscal space at the level of the Eurozone.

An example is a common unemployment insurance scheme that would insure the cyclical component of unemployment (so as to minimise moral hazard problems). This insurance scheme should have a large component of insurance over time. We have made a proposal for a business cycle stabilisation effort that could complement such an insurance scheme.

- Another small step is to start with a limited programme of debt consolidation.

That must take care of moral hazard issues that naturally arise with such schemes. The best way to achieve this is by introducing an element of co-insurance. This can be done by limiting the common issue of government bonds to a given percent of GDP, e.g. 60%. What exceeds this limit must be issued by the individual government (see Delpla and von Weizsäcker 2010).

These are small steps. Even these small steps, however, encounter severe hostility and will be difficult to take. Yet these steps will have to be taken if we want to avoid the future disintegration of the Eurozone.

Our task as economists is to make this choice clear to the rest of the population; we should tell them that if they want to keep the euro, steps towards more political union are inevitable. If they do not want to take these steps, they will have to say goodbye to the euro.

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Policies and institutions for managing the aggregate macroeconomic stance of the Eurozone[1]

Giancarlo Corsetti, Matthew Higgins and Paolo Pesenti
University of Cambridge and CEPR; Federal Reserve Bank of New York; Federal Reserve Bank of New York and CEPR

James Tobin's classic 'funnel' theory questioned how best to calibrate the overall stance of macroeconomic policy in an economic region. This column revisits key questions that emerged out of the EZ crisis through the lens of Tobin's theory. A key insight is that monetary policy cannot achieve stabilisation objectives without stronger mechanisms for fiscal burden-sharing and risk-pooling. Although short-run solutions are possible under the existing circumstances, long-run stability will require a policy mix that convincingly deals with the issue of fiscal risk-sharing.

> *"How do we decide the mix of policies? Assume that someone has decided on the total dose, that is, the path of GNP and unemployment. What is a socially rational choice of the mix of policies to support that decision? The mix does make a difference, much more for the long run than for the short run… Demand management strategy does affect the long-run capacity of the economy to produce. The policy mix makes that connection."* (Tobin 1986)

At the root of this eBook are three basic questions:

1 The views expressed here are those of the authors and not necessarily those of the Federal Reserve Bank of New York, the Federal Reserve System, or any other institutions the authors are affiliated with.

- What resources or institutional mechanisms proved absent or ineffective during the crisis?
- What worked well?
- What lessons for the future can be highlighted?

The specific vantage point of this contribution is to revisit these questions by focusing on macroeconomic policymaking in the Eurozone (EZ), in the tradition of the far-reaching body of literature on the policy mix epitomised by the classic 'funnel' theory of James Tobin. The key question for Tobin and his successors was how to calibrate the overall stance of macroeconomic policy in a country or economic region, choosing the combination of fiscal and monetary elements that deliver the appropriate degree of macro stimulus or restraint. In this light, in what follows we aim at considering the recent past and the potential future of the European macroeconomy using the evolution of the EZ policy mix as the Ariadne's thread to escape the maze of liquidity traps, low-inflationary pressures, and anaemic growth prospects.

What proved absent or ineffective during the crisis?

Let's start with what went wrong. Facing adverse cyclical developments, the absence of meaningful fiscal risk-pooling among EZ members forced less creditworthy countries into pro-cyclical fiscal tightening. Lack of fiscal capacity also left these countries unable to provide credible backstops for troubled domestic banking systems. Such weakness proved self-reinforcing, with capital flight and deteriorating financial conditions further undermining domestic economies and banking systems.

One could be tempted to read the parabola of the European periphery as a cautionary tale about the risks of fiscal profligacy, as countries with bad fiscal fundamentals were unable to cope with the consequences of the downturn by adopting appropriate countercyclical stimulus. But there was no meaningful fiscal loosening even in countries with fiscal space, except briefly during the height of the Great Recession; indeed, policy often went in the opposite direction. In Germany, for example, the European Commission's measure of the cyclically adjusted primary balance tightened by 2.3 percentage points relative to GDP over 2010-13. The general thrust of policy discussion was toward structural reform and belt-tightening, measures at best ineffective in meeting a large demand shortfall.

In parallel with fiscal policy, monetary conditions were tight when the crisis hit. Estimates of the neutral (or natural) real interest rate moved quickly into dangerously low if not negative territory, reflecting a sudden deterioration in financial conditions encompassing widespread deleveraging, reduced risk appetite, and revised expectations about growth and employment prospects. These developments came on top of slow-moving structural factors depressing the natural rate, including demographic developments and globalisation trends. Closing the output gap or fighting deflationary tail risks in the face of a low neutral rate requires very low nominal policy rates and relatively high inflation expectations. Implementing this strategy is difficult enough when central bank policy runs into the constraint set by the zero (or effective) lower bound (ZLB) and resorts to unconventional policies of unknown or doubtful efficacy to meet its mandate. But it can be argued that, at first, the ECB was actually reluctant to pursue this route. Policy rates were hiked as late as July 2008, and not eased until September. Perhaps more puzzlingly, the ECB embarked on an abortive new tightening cycle in April 2011.

In the EZ this raised doubts about policymakers' commitment to the 2% target and allowed inflation expectations to ratchet downward. At the country-specific level, membership in the currency union meant that real exchange rate misalignments within the EZ could only be cured through the slow process of internal devaluation. Low inflation in the core implied deflation in the periphery.

As the bank-lending channel plays a key role in the mechanism of transmission of monetary policy in the EZ, market and policy pressures pushing banks to deleverage in the aftermath of the crisis reduced the effectiveness of monetary stimulus. Quantitative easing and associated forward guidance, when they were finally adopted in force in late 2014, proved relatively effective in flattening the yield curve, but quite ineffective in supporting inflationary expectations. Indeed, swap pricing suggests that inflation is expected to average barely 1% three to six years ahead, below when the ECB's expanded asset purchase program was rolled out in March 2015. Disagreement among policymakers and problematic communication about the direction of policy may have worked to undermine the effectiveness of forward guidance.

What worked well?

On a more positive note, after the inception of the crisis in August 2007, the ECB proved to be quite effective in addressing the malfunctioning of the interbank markets. Like other central banks in advanced economies, the ECB progressively increased the scale and scope of its interventions in such markets, preventing their stoppage and creating the preconditions for a return to normality, at least in the secured segment. In the case of the EZ, the improvement was nonetheless complicated by the uncertainty emanating from the EZ debt crisis. Namely, worries about sovereign debt triggered significant fragmentation in money markets in the EZ. The combination of sovereign and counterparty credit risk concerns led investors to search for safe and liquid assets across national borders.

The Target2 system worked very smoothly, ensuring that the massive withdrawal of funds from the periphery by the banks in the lending countries, capital flight, and loss of bank reserves, did not produce any 'balance of payments crisis' within the EZ. With the growth of the balance sheet of the ECB, stepping in and substituting for trade in the interbank system, the operations that involved cross-border banks amounted to credits extended to the periphery countries in excess of any historical IMF program (in percentage of GDP).

The ECB proved proactive in 'credit easing,' to address strains on national banking systems, authorising national central banks (NCBs) to accept a broader range of collateral and to lend at full allotment in refinancing operations with local commercial banks. This strengthened the ability of NCBs to inject liquidity into local banking systems, and kept periphery countries from seeing the sharp shrinkage in domestic credit that normally accompanies large-scale capital flight. The exchange rate relative to the EZ's main trading partners acted as an important and effective transmission tool for monetary policy, including unconventional policy tools. As a more general point, the biggest and most consequential surprise of the crisis period and its aftermath was that populations in the periphery proved willing to suffer significant deprivations in order to remain in the EZ.

Last but not least, the launch of the Outright Monetary Transactions (OMT) program proved to be an effective measure to reign in the variable and large risk premia on government debt that, after 2010, had driven the interest differentials across member states to levels not seen since the first half of the 1990s. Just as there was no mechanism for restraining growing imbalances in the current account during the run-up to the crisis, after its outburst there was virtually no mechanism to contain the risk of destabilising capital flow reversals, feeding high and variable risk premia, possibly disconnected from fundamentals. The OMT program created the possibility for the ECB to intervene in the debt market with the explicit goal to address issues in self-fulfilling expectations of debt default and/or break-up of the EZ. Its launch, in conjunction with the famous 'whatever it takes' speech by Draghi in July 2012, had a strong calming effect on financial markets. Interest rates remained higher in countries with relatively weak public finances and macroeconomic & banking conditions, but their dynamics turned out to be better anchored to developments in domestic fundamentals.

What are the lessons for policy design going forward?

In the short term, some of the headwinds from the past crisis are likely to linger on. And given the demographic and productivity trends, measures of the real neutral interest rate are expected to remain subdued over the medium term. If secular stagnation theories prove correct for the EZ, low real equilibrium rates may be with us for the foreseeable future. In light of this, the EZ needs to prepare for the possibility of hitting the ZLB again & again going forward, not because the risks to the outlook are persistently tilted on the downside, but because real rates consistent with a neutral monetary stance are likely to be lower than historical averages.

If this is the case, EZ monetary policymakers may want to consider the benefits of temporarily overshooting the 2% inflation objective. Moving away from the notion of 2% as an inflation ceiling – as currently envisioned in the EZ monetary framework – toward a symmetric inflation objective is unlikely to be an easy task. Even in the US – where an objective for inflation has been long recognised as an integral component of the 'dual mandate' – it took until January 2016 (in the newly revised Consensus Statement) to make it explicit that such an objective is symmetric, and that FOMC participants are equally concerned with inflation deviations below and above mandate-consistent levels. But moving toward a symmetric objective in the EZ may come with even stronger benefits, by expanding the expected policy space to escape current and future liquidity traps and re-anchoring longer-term expectations around the desired level. In a region facing risks of persistent headwinds (if not secular stagnation), a longer-term posture of 'opportunistic re-inflation' might go a long way in stabilising expectations. A move toward a symmetric objective raises non-trivial communication challenges, but may well be considerably less onerous than the adoption of a higher numerical inflation target – which would raise concerns about long-term social costs and undermine public confidence in the determination of the central bank to pursue price stability – or a more radical switch to regimes of targeting the price-level path or nominal income.

Facing these prospects, a number of 'unconventional' strategies of monetary policy adopted in the recent past may get promoted to the 'conventional' range, and join the permanent toolkit of the ECB, ready to support the appropriate degree of monetary stimulus in response to obdurately adverse circumstances. That is, monetary policymakers may need to rely on asset purchases and allow the policy rate to fall into negative territory more often than originally planned by the EZ architects. Negative rates may have a better chance of getting upgraded to permanent instruments of demand management in the EZ, in contrast with the experience of the US, where negative rates have not emerged as an unconventional tool. Large-scale asset purchases seem to have done visible good both in the US and the EZ; in the EZ in particular, borrowing rates for corporates are significantly lower than they were two or three years ago. As already noted, however, inflationary expectations haven't responded in a meaningful way to programs of quantitative easing and periods of prolonged balance sheet expansions. Tools more directly related to affecting currency valuations are much less likely to be considered in the design of the future policy mix, even though the exchange rate channel is certainly a powerful element of the transmission mechanism.

All of the above notwithstanding, at the ZLB, monetary policy by itself will not be sufficient to achieve stabilisation objectives. There need to be stronger mechanisms for fiscal burden-sharing and risk-pooling. The EZ will remain a semi-functional monetary union so long as such mechanisms are lacking. In this direction, one could consider creating room for fiscal policy to achieve the correct macroeconomic stance at EZ level, while preserving fiscal sustainability at the national level.

Alternative institutional developments may be functional to this goal, entailing different degrees of transfer of national sovereignty to common institutions and decision-making bodies. But it should be clear by now that a successful institutional development in this direction cannot occur without any transfer of sovereignty.

In particular, the management of a common macroeconomic stance may be particularly difficult without addressing two open issues. The first is the creation of a safe asset for the EZ as a whole - a bond which is effectively considered free of default risk in nominal terms. The second is the definition of institutions and procedures for an orderly management of debt restructuring at the national level, in case the legacy debt - whose growth has not been unrelated to the effects of the crisis - turns out to be unsustainable.

Future directions

We sketch hereafter the directions that reforms could take. The literature has discussed several variants of instituting a fund with the ability to buy national public debt (from countries satisfying specific fiscal criteria) and issue a safe asset, in the form of Eurobonds, with an explicit ECB backstop. Since the onset of the crisis, concerns about keeping default risk premia on national debt as low as possible have clearly acted as a drag on reasonable use of fiscal space at the national level for procyclical expansions. The OMTs have in part addressed this issue, by shielding countries from disruptive, self-fulfilling debt selloffs. They have not, however, eliminated the contractionary bias for the EZ level. With the fund issuing safe common bonds, the EZ as a whole could respond to large shocks with sufficient fiscal determination while containing vulnerability to sovereign crises.

This fund could naturally be given the responsibility to coordinate fiscal policy in response to Euro-wide shocks. In normal times, its main function would not interfere with national fiscal policymaking. In the presence of large recessionary shocks, it would take charge of setting the required degree of fiscal accommodation at union-level, which may possibly require short-run deviations from deficit criteria in some countries.

The Fund, together with the ECB, would guarantee the face value of its bonds, not of national public debt. Access to the fund would only be conditional on clear fiscal criteria, ensuring fiscal discipline at the national level, and would be denied to countries violating these criteria.

For this reason, the viability of the scheme requires the creation of a framework for managing restructuring in an orderly way. This framework should be designed with the explicit goal of preventing credit events from feeding (self-validating) expectations of exit and thus ruling out breakup risk. To set the right incentives to restore fiscal viability, the Fund would stand ready to resume debt purchases after restructuring, conditional on the government complying again with the fiscal criteria.

These criteria should, of course, be set to minimise possible opportunistic behaviour. But it is worth noticing that exposure to risk of default per se would to some extent foster discipline.

One could argue that, in part, an appropriate policy mix could already be achieved in the present circumstances, with the ECB keeping its monetary stance appropriately accommodative and issuing reserves in order to purchase national public debt – as implemented in the more recent Public Sector Purchase Program. Member states could move further from fiscal consolidation to limited fiscal accommodation. But while this shift may be a sensible option in the near future, if the global outlook deteriorates, there is no reason to be confident that the macroeconomic stance would become sufficiently expansionary, implying a concrete risk of overburdening monetary policy. It is difficult to think of the future of the EZ without a convincing answer to the issue of creating fiscal risk sharing in Europe.

Concluding remarks

A key lesson from the global crisis and the Great Recession focuses on the disruptive effects of financial risk, endogenously magnified by various types of market distortions and coordination problems. The economic regions that were most successful in reigning in this risk were the most effective in containing the economic costs of the crisis. In the case of the EZ, an incomplete institutional development has long delayed this process, often feeding, rather than containing, endogenous risk. The difficulties so far experienced in sustaining economic activity can and should be overcome, however, by recognising that macroeconomic stabilisation needs instruments and policies that square at the EZ level.

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Asymmetries and Eurozone policymaking

Tommaso Monacelli
Bocconi University and CEPR

The boom-bust cycle in the Eurozone between 2000 and 2008 is essentially a story of cyclical asymmetries between the Core and the Periphery. While stressing the importance of addressing these asymmetries – especially via fiscal policy – the ECB has failed to take them explicitly into account in its own policy-setting. This essay argues that these asymmetries may persist precisely because they are not a central target of stabilisation policy – both fiscal and monetary.

The prolonged slump in the Eurozone since 2008 reminds us that asymmetric shocks in a currency area matter substantially – as the classical on optimal currency areas literature pointed out more than a half century ago (Mundell 1961, Kenen 1969). However, while the original shock triggering the crisis was a sudden stop in capital flows to the Periphery (Baldwin et al 2015), the fact that it happened in an area of permanently fixed exchange rates was unprecedented, and magnified the scale of the problem.

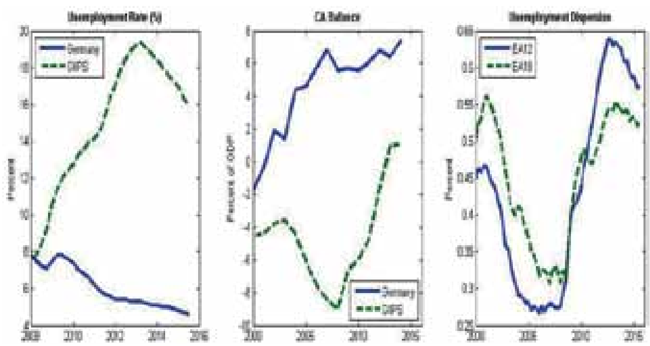
This raises a new (and EZ-specific) set of policy questions. The first is: How can we prevent and tackle sudden capital flow stops in a currency area?

More than any other developed economy in the world, the Eurozone currently looks prone to slide into a Japanese-style prolonged malaise. There are similar symptoms, such as the fragility of the banking system and the burden of accumulated sovereign debt in several countries. But, relative to Japan in the nineties, there are, as well, new specificities.

- First, the apparent re-emergence of hysteresis in unemployment (Blanchard and Summers 1985, Galí 2015).
- Second, a pronounced and persistent asymmetry in the unemployment rates between the Core and the Periphery.

The latter feature is illustrated in the left-hand panel of Figure 1, which plots the persistent gap in the unemployment rates between the so-called GIIPS countries (Greece, Ireland, Italy, Portugal and Spain) and Germany since 2008. This suggests a second EZ-specific policy problem – how can we tackle hysteresis in the presence of a persistent regional asymmetry in the unemployment rates – especially in light of a binding zero lower bound (ZLB) constraint on monetary policy.

Figure 1 Unemployment rate (left) , CA balance in GIIPS and Germany (central), dispersion in unemployment rates in all EA countries (right).



Note: Dispersion is computed as cross-country standard deviation normalised by cross-country mean.

The central panel of Figure 1 depicts the evolution of current account imbalances between Germany and the GIIPS; whereas the right-hand panel depicts the evolution in the dispersion of unemployment across all EZ members since 2000. Notice that the 2000-08 period of widening current account imbalances corresponds to a narrowing of unemployment dispersion, with the reverse pattern emerging with the onset of the crisis. In other words, when asymmetries vanish in one dimension, they re-emerge in another.

The above evidence illustrates clearly that asymmetries constitute a central problem for EZ policymaking. The boom-bust cycle between 2000 and 2008 is essentially a story of cyclical asymmetries between the Core and the Periphery – initially, widening relative competitiveness and current account imbalances; then, deeply asymmetric recoveries.

I will start discussing the role of asymmetries from the perspective of monetary policy, but will suggest that the same arguments might naturally lead to a reconsideration of how fiscal policy should be conducted within the EZ.

Monetary policy and cyclical asymmetries

A central policy question is whether asymmetries should be viewed as a natural feature of a currency area, or as a structural problem. Broadly speaking, asymmetries can be of three (not mutually exclusive) types:

- First, asymmetries in shocks (i.e., country-specific disturbances);
- Second, asymmetries in structural features of the economy (e.g., price and/or wage rigidity, or frictions in labour/goods markets); and,
- Third, asymmetries in business cycles, due to the combined effect of the first two asymmetries.

It is important to emphasise that asymmetries in a currency area should not be prevented per se. Asymmetries should be relevant for monetary policy decision-making to the extent that asymmetries in business cycles are due to asymmetries in shocks and structures. This is what should be meant by cyclical (and inefficient) asymmetries.

- Under these conditions, asymmetries generate an inefficient degree of divergence in business cycles (a 'business cycle-divergence gap'); that is, an excess cross-country dispersion relative to what should be deemed natural as a mere result of country-specific disturbances.

Simply put, monetary policy in the EZ does not address cyclical asymmetries. In fact, complacency on this matter has persisted during the 'EZ Great Moderation phase' (2000-08), probably due to the optical illusion that asymmetries among member countries were gradually vanishing. Even worse, the ECB conducted policy 'as if' those asymmetries did not exist. Two prominent examples suffice. First, the ECB accepting sovereign bonds as collateral in Repo transactions as if those bonds were perfectly substitutable. Second, the ECB inflation target being expressed as an average inflation rate as if the EZ was a relatively homogenous (and closed) economy.

It is therefore natural to ask what the cost might have been (and still could be) from the ECB's neglect of asymmetries. In the presence of cyclical asymmetries of the third type, it is conceivable that, for example, targeting a simple average inflation rate might have entailed large welfare costs.

What does economic theory suggest?

The recent literature suggests a consistent message when it comes to the role that asymmetries should play in monetary policy making. Unlike a homogenous, closed economy and/or a multiple country setting with flexible exchange rates, the optimal monetary policy objective function in a currency area should feature the following two targets (Benigno 2004, Corsetti et al 2011):

- A nominal rigidity-weighted (rather than GDP-) average of the inflation rates of the member countries (i.e, with weights reflecting the respective, country-specific, structural frictions, such as the degree of price or wage stickiness and/or the degree of persistence in inflation); and,

Therefore the inflation rate of the Periphery – comprising the so-called GIIPS countries where nominal rigidities are structurally higher – should hold a higher weight than the inflation rate of the Core.

- A within-Eurozone terms-of-trade gap (i.e., the deviation of the current within-Eurozone terms-of-trade from its natural value; the one prevailing in the absence of nominal rigidities).

Variations in relative competitiveness across regions (of which we had a vigorous manifestation during 2000-08) should be adequately addressed, rather than neglected.

- Targeting the arithmetic (or GDP-weighted) average inflation rate in the EZ is hardly justifiable in terms of efficiency. More broadly, what matters in a currency area is not only the average level of inflation, but also its *composition*.

To better appreciate this point, and as a mere illustration, we conduct the following exercise. We first draw information on the average frequency of price changes for EZ countries from the micro-data based study by Dhyne et al. (2005). These data are reported in Table 1. The higher the value of each entry, the higher the degree of price flexibility. Next, we compute an index of price rigidity for each country as the inverse of each entry, and take the average of that index for the Core and the Periphery countries.[1] Finally, we compute an artificial nominal-rigidity weighted HICP inflation rate, weighing Core and Periphery according to their relative degree of price rigidity. Noticeably, the outcome of this exercise is that, in computing the weighted average inflation rate for the EZ, the relative weight of the Periphery should be higher than the one of the Core (respectively 0.557 vs 0.443).

Table 1 Percentage of prices changing in a given month

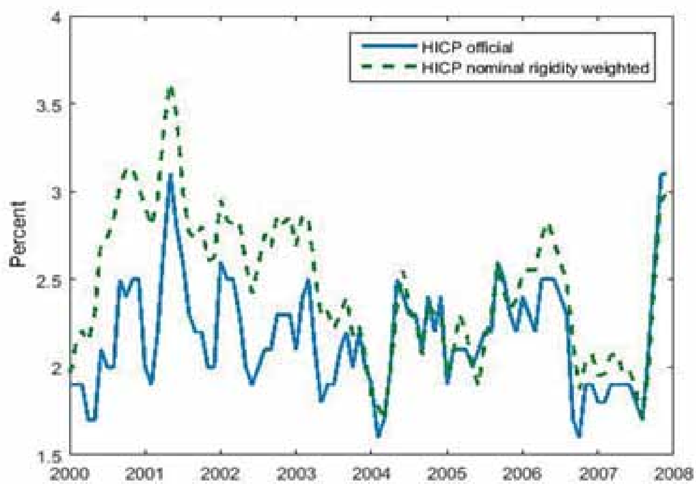
Belgium	17.6
Germany	13.5
Spain	13.3
France	20.9
Italy	10
Netherlands	16.2
Austria	15.4
Portugal	21.1
Finland	20.3

Source: Dhyne et al. (2005).

1 Based on Table 1, the Core countries are Belgium, Austria, Germany, Netherlands, France and Finland; the Periphery countries are Italy, Spain and Portugal.

Figure 2 displays the HICP official inflation rate for the EZ against the nominal-rigidity weighted HICP inflation series obtained with the above procedure.

Figure 2 HICP inflation rate: official vs. nominal-rigidity weighted



Consider now the current state of the EZ economy. While raising the average inflation rate back to its target is certainly desirable, it should not be neglected that what the EZ needed since 2008 (and still needs) is an adjustment in the Core-Periphery real exchange rate. Against this background, and to the extent that it characterises itself as relative deflation in the Periphery, the current 'deflation (or low inflation) evil' might appear under a different light. Notice, though, that 'relative deflation' in the Periphery might result not only from absolute deflation in the Periphery, but also from inflation in the Core (or both).

On the other hand, it should be acknowledged that, currently, part of the overall area-wide low inflation symptom is the direct implication of a persistently binding ZLB constraint. Therefore:

- A further, currency area-specific policy problem consists of distinguishing between the benign relative deflation signal (i.e., the one fostering the required terms of trade adjustment between core and periphery) and the malign one (i.e., due to the occurrence of the ZLB).

Monetary policy and structural reforms

The way the ECB has so far addressed the asymmetry problem is in its enduring emphasis on 'structural reforms' (allegedly to be implemented in the periphery). Very few central banks in the world (if any) make the reference to structural reforms such a persistent argument of their official policy statement. However, while the ECB acknowledges that structural asymmetries do exist (and are important), it fails to take them explicitly into account in its policy setting.

Put differently, the current policymaking environment in the EZ holds that:

i. structural asymmetries should be dealt with by fiscal policy; and,

ii. monetary policy should be vocal about the importance of reducing structural asymmetries, but should refrain from taking them explicitly into account.

Invoking the reduction of structural asymmetries (the so-called 'structural reforms'), however, without an explicit, country-specific, aggregate demand management, might even be counterproductive. Consider, for instance, the repeated emphasis, in the aftermath of the EZ crisis, on labour market reforms and enhanced wage flexibility (to be implemented in the periphery). The argument holds that, in light of the asymmetric shock that hit the periphery between 2008 and 2011, a wage-based 'internal devaluation' is warranted to offset the lack of exchange rate flexibility.

For the sake of argument, let's think what happens, in an economy, if wages are 'made more flexible'. For one, wages will be more unstable (which is a cost); but, on the other hand, employment will be more stable (a benefit). What determines the breakdown between 'higher wage instability' and 'higher employment stability' is the ability of monetary policy to manage aggregate demand – the stronger this ability, the larger the benefits in terms of employment stabilisation relative to the costs in terms of wage volatility. In the EZ, however, where monetary policy does not respond to asymmetric disturbances, a mere emphasis on higher wage flexibility in the periphery might result, almost exclusively, in higher wage instability, with limited benefits in terms of employment stabilisation (Galí and Monacelli 2015). Therefore:

- In a currency area, policies addressing asymmetric aggregate demand deficiencies are *complementary* to structural (supply-side) reforms.

Importantly, this argument reinforces the idea that monetary policy should tackle asymmetries ex ante, by targeting inflation rates asymmetrically and/or by explicitly targeting the within-area terms of trade. It should be noted, however, that the same argument equally supports the view that fiscal policy (in its aggregate demand management dimension), alongside structural reforms, should be actively used to address asymmetries. We will return on this point below.

Current account asymmetries

How to optimally manage international capital flows is among the most prominent policy dilemmas of our times, and particularly so within an area of permanently fixed exchange rates. The magnitude of cross-border capital flows observed during the 2000-08 boom-bust EZ cycle, from the core to the periphery and vice versa, was a vigorous manifestation of the relevance of asymmetries within a currency area (see again Figure 1).

What role the management of capital flows should play in optimal policymaking, and especially within a currency area, remains a largely unexplored issue. Even less is known about the appropriate tools to tackle the problem. Certainly, capital controls as policy instruments are once again fashionable (IMF 2011).

The general, more recent, view is that capital controls should be used to address externalities. The latter are of two different types:

1. pecuniary externalities, deriving from asset valuations affecting the ability of private agents and financial institutions to borrow (in the presence of credit market imperfections – Lorenzoni 2011, Bianchi and Mendoza 2010, Bianchi 2011) ; and,
2. aggregate demand externalities (deriving from the presence of nominal rigidities – Farhi and Werning 2012, Korinek and Simsek 2015).

'Financial' externalities of type (i) typically arise from cross-border capital flows (already so prominent within the EZ), giving rise to current account imbalances. Aggregate demand externalities of type (ii) are a genuine feature of a currency union, due to the combined effect of nominal rigidities and permanently fixed exchange rates. It is important to notice that the aggregate demand externality argument is exactly the one (expounded above) whereby optimal monetary policy in a currency area should target the within-area 'terms of trade gap'.

Presumably, each type of externality might require the design of a different policy tool. This is a central, but much less understood, question, which definitely warrants further research work.

- There is however a common element – both types of externalities give rise to misalignments in international relative prices, with potentially destabilising effects.

Those effects can be dangerously exacerbated by the participation in a currency area, due to the impossibility of correcting them (either ex ante or ex post) via variations in nominal exchange rates. This observation reinforces the argument, already suggested above, whereby optimal policy in a currency area should give a more prominent role to targeting the within-area terms of trade (or, more generally, the composition of inflation). Whether capital control tools should be used by monetary or fiscal authorities, and whether or not they should be used in a state-contingent fashion, still remain open issues. Fernandez et al (2015) show that, historically and in stark contrast to theory, capital controls are largely acyclical. In light of recent theory, there are therefore strong reasons for employing those tools in a more active fashion, especially within a currency area.

Macroprudential framework, asymmetries and coordination (or lack thereof)

With the onset of the 2011 crisis, the EZ has endowed itself with a new, and somewhat complicated, macroprudential framework (Gadatsch et al. 2015). In this framework, a macroprudential role played by the Ecb in the banking sector co-exists with country-specific institutions aiming at the implementation of regulatory tools such countercyclical capital buffers or loan-to-value ratios. Currently, all EZ countries have either legislation in force or are finalising laws to designate a single macroprudential authority. Although these are general steps in the right direction, they suffer of the same, and fundamental, flaw that affected the design of the fiscal policy framework at the onset of the EZ: a basic lack of coordination.

This lack of coordination in macroprudential policy is potentially highly problematic. For the externalities stemming from the coexistence, within a currency area, of nominal rigidities and fixed exchange rates generate cross-country spillovers similar in nature to those that justify the presence of a common set of fiscal rules, and currently incorporated in the so-called Fiscal Compact. For instance, overborrowing in the Periphery leads to an excess appreciation of the terms of trade in the Periphery (and, simmetrically, to an excess depreciation in the Core), increasing the likelihood of capital account reversals, which in turn bear (as the EZ crisis manifestly witnessed) area-wide aggregate implications.

Fiscal policy and asymmetries: An argument for coordination

The reasoning so far has focused on monetary policy. Most of the arguments, however, might well support the notion that fiscal policy, rather than monetary policy, should be used to address cyclical asymmetries. All arguments outlined above, in fact, can be interpreted as supportive of some form of fiscal union. However – what exactly should be understood by fiscal union?

Our previous analysis has highlighted three main economic arguments that support the desirability of a fiscal union:

- The presence of an aggregate demand externality (rooted in nominal rigidities coupled with fixed exchange rates), which implies that the within-area terms of trade adjust inefficiently;
- The presence of a pecuniary externality (rooted in financial imperfections), which gives rise to 'excess' within-area capital flows; and
- The notion that implementing region-specific supply side reforms (aimed at addressing structural asymmetries) should be complemented by a region-specific management of aggregate demand.

A fiscal union is therefore any fiscal policy arrangement aimed at addressing these. Whether a fiscal union should take the practical form of (state contingent) capital controls, taxes, government spending, or transfers is a fundamental issue which remains open to debate.

Here I wish to emphasise a different angle:

- In the EZ public discourse, 'fiscal union' invariably means fiscal policy *simultaneity*.

For instance, the so-called 'Juncker plan' of EZ-wide public investment in infrastructures. However, what a fiscal union should primarily evoke is a correct concept of policy *coordination*.

This means fostering the notion that, in the presence of cyclical asymmetries, an asymmetric fiscal policy response is desirable from a social welfare perspective. In practice, fiscal policy coordination means that, in light of a regional slump caused by an asymmetric sudden stop in the Periphery, a coordinated EZ fiscal stimulus might well contemplate cutting taxes (or increasing government spending) only in the Periphery

(Galí and Monacelli 2008) – with the understanding that, to put it bluntly, this would be in the interest of the Core countries as well. Hence, and to summarise:

- In the presence of cyclical asymmetries (of the inefficient type discussed above), it is desirable from a social (i.e., union-wide) welfare perspective for fiscal policy to be asymmetric.

Consider, for instance, the current debate on the desirability of using 'fiscal space' to address the weak recovery in the Periphery (particularly prominent in Italy). Presumably, it would make a substantial difference, especially in terms of market sentiment, whether a fiscal expansion (e.g., a tax cut) were implemented in the Periphery only as a form of coordinated fiscal response, as opposed to being the result of a lengthy and discretionary bargaining process unilaterally promoted by a single member country.

This is the correct logic of fiscal coordination (as far as stabilisation policy is concerned), which is still lacking in the current EZ version of fiscal coordination – the so-called Fiscal Compact. Notice that this argument does not necessarily imply that fiscal policy should be centralised in the hands of a single fiscal authority (a desirable outcome per se, but probably unrealistic, even in the medium run). What 'fiscal coordination' ought to mean, though, is that, in light of cyclical asymmetries, a cooperative (and union-wide optimal) fiscal policy response should be asymmetric in nature – that is, targeting country-specific demand deficiencies in the interest of stabilising area-wide macroeconomic conditions.

Conclusions

Asymmetries are a defining feature of the EZ. Many believe they should be dealt with by supply-side, long-run reforms since they are 'structural'. In this mind set, the asymmetries are taken as given when it comes to monetary and fiscal stabilisation policy. It is however plausible that cyclical asymmetries continue to persist in the Eurozone precisely because they are left un-tackled by stabilisation policy. The boom-bust cycle of the Eurozone was a plain manifestation of the dire consequences of this neglectful attitude. It seems therefore of paramount importance that EZ policymaking, whether monetary or fiscal, re-considers cyclical asymmetries as a central target of its framework.

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ECB in Eurozone policymaking: Going forward

Refet S. Gürkaynak
Bilkent University and CEPR

Since the beginning of the Global Crisis, the ECB has faced a sequence of problems. This column discusses some of these problems. It also highlights the successful first reaction of the ECB to the crisis and its adequate monetary policies. There are still unresolved structural problems in the Eurozone, however. Among them are the lack of a proper banking union and the need for a better fiscal policy coordination. And the job for such a change within the Eurozone cannot be delegated to the ECB.

In the past decade, beginning with the Global Crisis, the ECB faced a sequence of related but distinct problems. These began with a financial crisis due to the US mortgage crisis, continued with a second financial crisis due to the European debt crisis, and is ongoing with a very slow exit from recession with inflation teetering at the border of negative rates. In analysing the efficacy of ECB policies and thinking of what more can be done, it is important to separate the crises from the recession.

ECB successful at crisis firefighting

Central banking was invented as a backstop for banks to help avoid bank runs. It then evolved into cyclical policymaking. The Global Crisis made it clear that central banks are still very adept in fulfilling their initial mandate; many central banks around the world, including the ECB, did an admirable job of doing firefighting by providing liquidity to illiquid institutions. This took place sometimes by finding ways to extend the playbook by creatively providing liquidity to non-bank financial institutions in need, often despite political pressure against such policies. But it is essential to note that we did not have waves of bank failures due to illiquidity in the Eurozone. ECB has been successful in crisis firefighting.

It appears that the various facilities ECB had in place to assist the banking sector during crises have been useful. In this regard, when a financial shock hits again, the ECB is well placed to get liquidity to the institutions that need it. However, the Eurozone as a whole continues to have difficulties with recapitalising the banks. The US benefited a lot from the forced recapitalisation of its banks during the crisis but a recapitalisation of the banking system to a similar degree did not take place in the Eurozone. This remains a weak point both in terms of financial stability and in terms of creating headwinds for growth.

After the crisis came the recession. This time the central banks had to perform their duties as cyclical policymakers. The Eurozone recession was a double dip one according to CEPR's business cycle dating committee, with a recession due to the Global Crisis between 2008Q1 and 2009Q2 and then a second recession due to the European debt crisis, between 2011Q3 and 2013Q1. The public can be forgiven to think that there has been one long recession since 2008--expansions have been very weak. This at least in part due to the zero lower bound and insufficient fiscal expansion and even retrenchment. So what is monetary policy to do?

Monetary policy of the ECB

My view is that ECB monetary policy has done what it can. The past decade taught us much about the limits of monetary policy. The limit is not only due to the zero lower bound. Barnichon and Matthes (2015), and Tenereyro and Thwaites (2015) convincingly argue that monetary policy in the US does not work well as an expansionary tool, independently of the zero lower bound. Although it is not as formally documented, it appears that a similar asymmetry is present in monetary policy effectiveness elsewhere as well. Central banks are able to slow economic activity and bring inflation down but are not as able to do the reverse. Hence, expecting monetary policy to fight against a recession, especially at the zero lower bound, is faith misplaced.

Central banks, including the ECB, have tried. Quantitative easing at the zero lower bound is central banks' way of saying they are the only adults among policymakers and will try to help bolster demand with unconventional policies even when it is not clear why these policies would work, and more importantly, fiscal policy would certainly work. My reading of the evidence is that QE has not directly hurt but has not helped much either. Indirectly there has been at least one important cost.

As central banks are expected to bear the burden of bolstering demand, and volunteer for doing so, fiscal policymakers are left off the hook and focus on their idiosyncratic objectives. Unfortunately, during the recent episodes, those objectives in Europe were not for fiscal expansion. This is a particularly acute case of monetary policy becoming the residual claimant of all policy needs and other policymakers behaving sub-optimally knowing that central bankers will step up and take the blame for the weak economic outcomes. Troy Davig and I discussed the perils of central bankers as policymakers of last resort (2015a, b). The Eurozone case is a sadly good example where the ECB's willingness to improvise policies to support growth has shielded the embarrassingly inept fiscal policies. Going forward, we have to rethink the job descriptions and responsibilities of various policymakers. There has to be more accurate finger pointing for the right policymakers to take the right steps. ECB must be less involved with problems it cannot solve.

Thinking about policy first requires the need for policy. What are the inefficiencies that necessitate policy interventions? Before asking for the ECB to do more, one has to be convinced both that there is an inefficiency and that monetary policy the right tool to address it. Banking (or more broadly financial intermediation) is subject to runs and crises which reduce welfare and call for policy action. The ECB has carried out this policy well and is well placed to continue playing this role as the lender of last resort. For other problems the ECB may not be the best policymaker.

Structural problems of the Eurozone

The crisis laid bare the structural problems of the Eurozone. Some of these were well understood. The Eurozone is not an optimal monetary policy area. Its labour markets are inflexible. Its fiscal policies are uncoordinated. With the crisis, we learned of one very important structural problem that was not as apparent.

- The Eurozone was not an optimal banking union area either.

The common banking passport created a more serious regulatory arbitrage than was thought and the fragmented banking and regulation landscape was a major problem. This issue is now being tackled with the ECB becoming a Eurozone level supervisor for large banks. This is a welcome response to the banking problems we observed and will help make Eurozone banking more resilient. In general, completing the banking union will help both in terms of supporting the real sector equally well in different Eurozone countries and in making European banking much better regulated. If done right, this will be a silver lining of the financial crisis.

Looking at the other inefficiencies, it must be clear that most if not all of them cannot be solved by monetary policy.

- Among other structural reforms, there is obvious need for better coordinated countercyclical fiscal policy.

This does not mean a new treaty on cross-country fiscal transfers or a unified fiscal policy. There is a very wide spectrum between the discombobulated and pro-cyclical fiscal policy on display now and a fiscal union. Even small changes in the right direction will produce large welfare gains.

It is important to see that structural reforms are political reforms that cannot be done by central banks. ECB is no exception. Eurozone unemployment by and large has to do with a combination of rigid labour markets in each country, the lack of sufficient intra Eurozone labour mobility, and real wage disparities at the inception of the euro. Some of these are political preferences: Eurozone citizens may choose to have employment protection and transfers to unemployed, in that case unemployment will be high. Flexible labour markets with less protection of the employed, in the Anglo-Saxon fashion, is also possible, which will deliver lower unemployment with higher churn. There may also be a preference for this. It is important to see that the ECB neither should nor can make that choice.

The Eurozone has a lot in common with emerging market economies with its problematic fiscal policy, deep need for structural reforms, and over reliance on its central bank for all economic policymaking. Similar to them, it will have to find the political will to change. That is a job that cannot be delegated to the ECB.

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Part 4

Focusing on structural and institutional reform

The Eurozone needs less heterogeneity[1]

André Sapir
Université Libre de Bruxelles, Bruegel and CEPR

Misalignments of real exchange rates continue to be the most visible and painful symptom of asymmetric shocks within the Eurozone. An important factor behind such misalignment is the difference in national wage formation and bargaining systems, especially between core and periphery members. This column argues that all members need to have institutions that ensure wage developments are in line with productivity developments. This would eliminate an important source of asymmetric behaviour and reduce resistance to EZ-wide fiscal mechanisms capable of absorbing asymmetric shocks.

Before the creation of the euro, the prevailing view in European economic circles was that economic and monetary union would reduce the incidence of asymmetric shocks. Policy-induced asymmetric shocks would be largely eliminated by the adoption of a single monetary policy and of fiscal rules that would impose sound national fiscal policies. Exogenous asymmetric shocks associated with structural differences between Eurozone (EZ) countries were also considered less likely because EMU was supposed to produce structural convergence among these countries (see Buti and Sapir 1998).

Misalignments of real exchange rates may not be the ultimate source of asymmetric shocks, but they are typically their most visible and painful symptom. Whatever their

1 This contribution is partly based on a paper prepared for the conference on 'Growth and reform in Europe in the wake of economic crisis' organised by the Banco de Portugal and held in Lisbon on 9 May 2015. The proceedings, edited by Francesco Caselli, José Tavares, and Mario Centeno, will be published by Oxford University Press.

fundamental cause, deviations of wage growth from labour productivity growth tend to create adjustment problems in a monetary union and should therefore be closely monitored and corrected before they become protracted and painful to adjust.

Unfortunately, the system of surveillance that operated in the EZ prior to the financial crisis was gravely deficient in this respect. In the days of the European Exchange Rate Mechanism, authorities monitored developments in real exchange rates (and competitiveness), and could use the nominal exchange rate to correct for losses in competitiveness. Prior to the crisis, however, national and European authorities seemed to have forgotten two elementary facts about a monetary union:

- First, that the loss of the nominal exchange rate instrument does not imply that real exchange rates cannot appreciate or depreciate; and,
- Second, that competitiveness adjustment risks being long and painful given the loss of the nominal exchange rate instrument.

As a result, real exchange rates in some EZ countries were allowed to become grossly over- or under-valued, creating difficult adjustment problems (see Levy 2012 for a related discussion).

Reducing the occurrence of asymmetric shocks in EZ

As Carlin (2013) emphasises, an important factor behind real exchange rate misalignment in the EZ, especially between the core and the periphery, is the difference in national wage formation and bargaining systems among its members. There is no easy solution to this problem.

One solution would be to harmonise wage-setting systems but this hardly sounds feasible given that national wage-setting systems have deep historical, political, and social roots. The alternative is to broadly maintain the existing systems but to constrain their functioning to ensure that they produce outcomes which are compatible with membership of a monetary union and the need to avoid persistent real exchange rate misalignment. This requires mechanisms to prevent and correct substantial misalignments of competitiveness between EZ countries.

The Macroeconomic Imbalance Procedure (MIP), established by the EU in 2011 in response to the economic and financial crisis, could be an important tool to monitor and correct macroeconomic imbalances in all EU countries. This is especially the case for countries belonging to the EZ for whom the MIP contains an enforcement mechanism, including the potential use of sanctions. The MIP's monitoring mechanism uses a set of indicators to assess macroeconomic imbalances and divergences in competitiveness.

In recent research, my co-author and I propose to complement the MIP by national procedures to monitor and, if needed, correct competitiveness problems and increase ownership at the national level (Sapir and Wolff 2015). These procedures would be required by EU legislation and their performance monitored by the European Commission.

All EZ countries would put in place a competitiveness-monitoring framework involving regular assessments and the definition of instruments to prevent problems. An interesting example is the Belgian legal framework, introduced in 1996 to preserve the country's competitiveness in the EZ by keeping the evolution of wages in line with wage developments in its main trading partners. A national body regularly reports on the evolution of Belgian competitiveness. This assessment is used by social partners to fix a wage norm for the next round of wage negotiations. Although the norm amounts only to a non-binding guideline, it has generally been respected by the private sector (to which the system applies). In case social partners fail to agree on a wage norm compatible with the evolution of competitiveness, the government can step in and make the norm legally binding. The system has worked fairly well – it left the wage formation and bargaining system that existed prior to the euro untouched, but made the behaviour of social partners compatible with membership of the euro. The result has been that unit labour costs in Belgium have evolved more-or-less in line with those in its main trading partners, thus avoiding significant competitiveness problems.

The Belgian system should not and cannot be exactly copied by other EZ countries, since they feature different wage-setting systems. What is important is that all EZ countries put in place a mechanism to ensure that, although operating within their own system, the behaviour of social partners and the outcome of their wage negotiations is compatible with membership of the euro, in terms of competitiveness and employment.

Improving adjustment to asymmetric shocks in EZ

The proposal to monitor and, possibly, correct labour competitiveness problems fits well with the Maastricht logic. This (implicitly) makes national authorities responsible for ensuring that national labour markets are sufficiently flexible to deal with asymmetric shocks. It also fits with the optimum currency area (OCA) literature which typically considers that the more a potential monetary union member risks being subject to asymmetric shocks, the more it needs labour market flexibility to compensate for the absence of the exchange rate instrument and adjust to such shocks (see, for instance, De Grauwe 2012).

However, the OCA literature never suggested that labour market flexibility, or even market flexibility in general, would be sufficient to deal with all asymmetric shocks. Instead it considered EZ-wide mechanisms to also be crucial, especially for big shocks. Two potential EZ mechanisms suggested by the OCA literature could have been labour mobility (as originally envisaged by Mundell 1961) or fiscal transfers (as first suggested by Kenen 1967) between EZ countries, but neither was promoted or put in place.

The Maastricht construction lacked one of the two adjustment mechanisms emphasised by the OCA theory – fiscal integration. The other mechanism, labour mobility, was theoretically possible by virtue of the EU treaties that guarantee the right of free movement of labour within the EU, but remained limited in practice.

The sovereign debt crisis came as a surprise. No one had foreseen that a EZ government could face a liquidity or even a solvency problem. As a result, the EZ contained no mechanism to deal with this crisis when it occurred. Several EZ countries found themselves suddenly unable to tap financial markets for their sovereign issuance and had to turn to supra-national public lenders. One source was the IMF, but EZ countries needed their own rescue mechanism. They eventually created the European Financial Stability Facility (EFSF), a temporary mechanism later replaced by a permanent rescue mechanism, the European Stability Mechanism (ESM). EFSF/ESM loans come with conditionality that, so far, has always included making recipients' labour markets more flexible. Hence, the new EZ regime set up in response to the financial and sovereign debt crisis includes an EZ risk-sharing mechanism in the form of fiscal assistance, along with structural reforms in product and labour markets.

Although this new regime is clearly better than the original EZ design it is still far from sufficient to provide the necessary adjustment within EZ.

What is still missing in terms of adjustment mechanism? Many support the notion that what the EZ needs is not so much a fiscal union per se, but an efficient risk-sharing mechanism that ensures both sufficient adjustment to asymmetric shocks and as little moral hazard as possible.

An international comparison of existing federations by the IMF shows that the EZ lacks the degree of risk sharing seen in other jurisdictions with respect to three dimensions (IMF 2014). First, contrary to federations such as the US, Canada, or Germany, which manage to smooth about 80% of local shocks, the EZ only manages to insulate half of that amount. Second, fiscal insurance compensates 25% of local shocks in Canada, 15% in the US, and 10% in Germany. In the EZ, fiscal insurance was virtually nil before the creation of the EFSF/ESM and remains very small. Third, most of the risk sharing in federations happens through private channels, mainly capital markets and banks. The EZ is no exception, but the role of capital markets is much less than in other jurisdictions.

The previous discussion suggests that the distinction between fiscal insurance and private insurance through financial markets, and the fact that the latter typically plays the dominant role in smoothing local shocks in federations, is not an argument against the need for a EZ fiscal union. On the contrary, the fiscal union should not only provide direct fiscal insurance but also a fiscal backstop against financial risks to allow private insurance to fully operate (see Gros 2014).

Even if an efficient fiscal risk-sharing mechanism can be designed,[2] there is little chance that it will be implemented as long as the fear of moral hazard and of the related 'permanent fiscal transfers' is present in the EZ. This fear largely reflects the heterogeneity that continues to prevail among EZ countries. In this respect, the Five Presidents' Report was right to emphasise that "there is significant divergence" across the EZ and that "completion of a successful process of economic convergence … would pave the way for some degree of public risk sharing" (Juncker 2015). What the Report has in mind is structural convergence predicated upon structural reforms geared towards "more efficient labour and product markets and stronger public institutions."

In political terms, this suggests that the acceptance by (some) EZ countries of steps towards a fiscal union will only be possible if (other) countries undertake major structural reforms. Whether structural reforms should be left entirely in the hands of national authorities, or if they would benefit from EZ coordination as suggested by Draghi (2015), is an open question.

Conclusion

Let us be honest. The EZ cannot go forward with the degree of heterogeneity in national labour market institutions and outcomes that currently prevails. All members of the monetary union need to have institutions that ensure that wage developments are in line with productivity developments. This would eliminate an important source of asymmetric behaviour among EZ countries that can lead to painful adjustments.

2 See Claeys et al (2014) for a discussion about the benefits and costs of a specific risk-sharing mechanism – European unemployment insurance.

At the same time, the EZ needs to put in place risk-sharing mechanisms capable of absorbing asymmetric shocks. Improving the functioning of capital markets in Europe would certainly be an important contribution towards that objective but fiscal mechanisms will also have a role to play. Yet there is much resistance in some countries to create EZ-wide fiscal mechanisms because they fear that structural weaknesses in other countries, in particular in the functioning of labour markets, will lead to structural rather than temporary fiscal transfers.

Reducing heterogeneity in labour market institutions and outcomes is therefore crucial for the sustainability of EZ.

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Balance-of-payments adjustment in the Eurozone

Stefano Micossi[1]
ASSONIME and CEPS

As a monetary union based on a single currency, the Eurozone is supposed to be immune from problems characteristic to fixed-exchange rate regimes. This column argues that this is not the case. The Eurozone still faces some adjustment problems. It seems unable to generate sufficient growth and inflation to place excessive public debt on a credible reduction path. It does not have a functioning adjustment mechanism to reabsorb existing competitive imbalances. In the long run, the Eurozone should aim to achieve a full integration of labour and capital markets. This is only feasible with budgetary and structural reforms in its member states.

History shows that – lacking an automatic balance-of-payments adjustment mechanism as under the gold standard – fixed exchange rate arrangements tend to break down under the attacks of financial speculation, but also that these attacks are encouraged by sustained divergences in prices, wages, and productivity. Countries with higher inflation and lower productivity growth typically display persistent public-sector deficits and rising debt-to-GDP ratios, which on occasion have become the trigger of confidence crises and speculative attacks in financial markets.[2]

1 Director General of ASSONIME, a business association and think tank in Rome, and member of the CEPS Board of Directors. He wishes to thank Daniel Gros and Franco Passacantando for useful comments, and Fabrizia Peirce and Alexandra D'Onofrio for outstanding research assistance.

2 See Eichengreen (1996) for a history of the International Monetary System and Bordo (1993) for a historical overview of the Bretton Woods exchange-rate arrangements. Under the gold standard – the longest-lasting arrangement in modern history – the balance-of-payments adjustment mechanism came close to resembling David Hume's price-specie flow mechanism, entailing an automatic correction of disequilibria through changes in gold reserves and relative prices in response to trade imbalances (or, in the more sophisticated version with central banks and capital flows, described by the Cunliffe Committee after World War I, via changes in money supply prompted by the conversion into national currencies of gold flows resulting from net trade balances; see Eichengreen (1996, pp. 25-26).

Incomplete monetary union under stress

As a monetary union based on a single currency, the Eurozone was supposed to be immune from these problems, as exchange-rate risks would vanish and payment disequilibria within the area would be smoothly offset by private capital flows (James 2012). These expectations proved delusional; the sovereign debt crisis in the Eurozone in 2010-12 started as a fully fledged balance-of-payments crisis (Baldwin et al. 2015), prompted by the accumulation of large payment imbalances between its members and reflecting persistent underlying divergences in prices and costs.

This happened because monetary union did not eliminate market segmentation and nominal rigidities, while fiscal policies stayed national and continued to respond to national goals, with inadequate attention to the convergence requirements of monetary union. The problem was brought back to the surface by the Greek debt crisis, early in 2010, which later turned into a sovereign debt crisis of the entire periphery. This latter crisis undermined mutual confidence amongst the member states concerning the respect of budgetary rules and reintroduced, in the eyes of private investors, a currency-redenomination risk. Hence, the Eurozone has de facto reverted to a fixed exchange rate arrangement between different 'national euros', each one characterised by its own risk premium or discount; the traditional problems of fixed exchange-rate systems – adjustment, liquidity, and confidence – have come back to haunt us. The confidence and liquidity problems are at present muted by the ECB bond-buying programme, but they are likely to re-emerge when the programme ends, if underlying imbalances in competitive positions and excessive public debt levels are not redressed.

This column describes the unresolved adjustment problems confronting the Eurozone and places them in historical perspective by comparing developments in key real economic variables under EMU with those observed under the Bretton Woods system. This comparison must, of course, be placed in proper context; while Bretton Woods covered much of the world economy, the Eurozone represents less than one-fifth of world GDP and about one-quarter of world trade. And yet the comparison is useful to highlight the different effects of the two systems on participating countries.

The main finding is that the Eurozone is afflicted by a strong deflationary bias and that, therefore, under current trends, deep economic and social strains will continue to project a dark cloud over its future survival.

Persistent imbalances

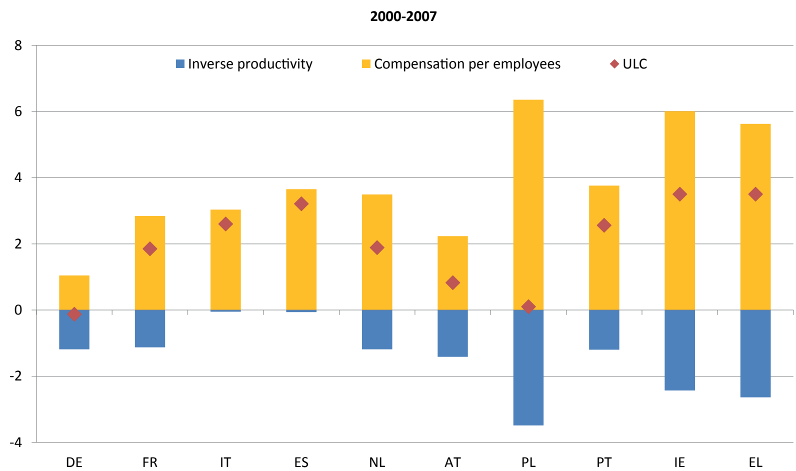
When the Eurozone started, Germany was still the 'sick man of Europe', mainly reflecting the dramatic cost of reunification. The response was a prolonged period of wage moderation by unionised workers (Bofinger 2015), in combination with reforms that increased labour market flexibility and created special low-cost contracts (the 'mini-jobs') that today employ over seven million people (Dustmann et al. 2014). The result was startling: from 1999 to 2008, unit labour costs declined by 9% in manufacturing and stayed constant for the total economy, leading to a rapid re-absorption of unemployment and a stellar export performance. Meanwhile, Germany's partners in the Eurozone were generally experiencing unit labour costs increases above the ECB inflation target of 2%, especially in the periphery. That was not least because of abundant credit flowing in from Germany and other 'core' countries following the vanishing of risk premia on peripheral borrowing.

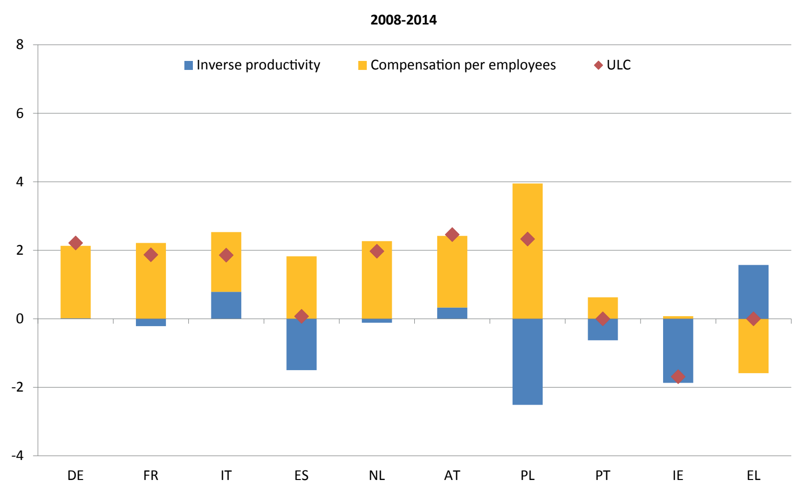
The overall impact on unit labour costs vis-à-vis the main Eurozone partners may be gauged from Figure 1. In the years preceding the Global Crisis, all Eurozone partners lost out heavily in their wage (and price) competitiveness relative to Germany. These losses were reversed in the ensuing years by the countries undertaking tough adjustment programmes to regain market access – i.e. Greece, Ireland, Portugal, and Spain – but not by the other partners, including France and Italy as well as other core countries.[3]

3 Figure 1 includes the data for Poland. It shows the strong advantage enjoyed by a non-euro country that could enjoy the benefits of low wages and rapid productivity increases thanks to its flexible labour market and fresh access to the EU internal market, without suffering the constraints of a fixed exchange rate in the face of the depreciating real exchange rate of Germany.

This has happened in spite of the acceleration of the wage dynamics in Germany, where a (rather high) minimum wage has been introduced by law and wage contracts have become more generous, as labour market conditions have tightened.

Figure 1 Unit labour costs, labour productivity, and labour cost (annual growth rates, %)





Note: Our updating of Graphs 5.16 and 5.17 from European Commission (2014) p. 90.

Source: Eurostat for productivity and ULC; Ameco for compensation per employee.

The upper quadrant of Figure 2 depicts the resulting evolution of real effective exchange rates (REERs) of Eurozone partners. As may be seen, the peripheral countries display a large real appreciation, only partially corrected since the Crisis, while the core countries (excluding Germany) display a moderate real depreciation. Germany stands out as the lower-bound outlier, with substantial real depreciation against all other Eurozone members in the pre-crisis period slowly reduced in the post-crisis years.[4]

In the middle quadrant of Figure 2, one finds the current-account imbalances of Eurozone members. The large deficit in the periphery closely mirrors the ample surpluses in the core. It should be recalled that the inception of the euro opened the way to an almost fivefold increase in Germany's trade balance with Eurozone partners between 1999 and 2007, which was the dominant component of its GDP acceleration in those years (and the slowdown in manufacturing in much of the periphery); and that the resulting surplus was only partially reversed (for about half of the total increase) in 2008-14.

After the Crisis, deficits shrank abruptly with falling domestic demand, as peripheral countries entered deep recessions; the surpluses were largely reabsorbed in core countries with the notable exception of Germany and the Netherlands. In 2013-15, Germany's surplus has remained on average above 7% of GDP, with its main counterpart shifting to emerging countries and, to a lesser extent, to the US. This development seems underpinned by a trend increase in aggregate saving, notably by the corporate sector, and a trend decrease in investment, relative to GDP; in the meantime the public sector deficit was all but eliminated, adding to aggregate domestic savings.[5]

4 European Commission (2016) points out that relative prices have been adjusting in response to cyclical conditions, more pronouncedly for unit labour costs and less for relative export prices. However, their impact has been 'slow to kick in' due to structural rigidities, the rising non-cyclical component of unemployment 'financial friction' (meaning that deleveraging firms have taken advantage of lower wages to raise profit margins, after several years of hard compression (pp. 14-5).

5 Various estimates seem to confirm that these developments are out of line with past analysis of the 'fundamental' determinants of the German current-account balance, and therefore a substantial part of the surplus remains unexplained (European Commission 2014). For one thing, the unprecedented and protracted slowdown in wages – required to save jobs from the impact of globalisation – flattened domestic demand through the first half of the past decade (lower quadrant of Figure 2); in the ensuing ten years (to 2015), domestic demand increased by less than 1% per year, opening an unprecedented gap with GDP growth – filled by net exports – which may well explain the reluctance of investors to invest.

The lower quadrant of Figure 2 calls our attention to another important feature of the post-crisis Eurozone system. After the Crisis re-established the diversity of national currencies and the balance-of-payment constraint, domestic demand and output growth in the rest of the Eurozone fell below those observed in Germany (as reflected in the relative slopes of the curves in Figure 2). In Figure 2 I have also reported the correlations between the current-account balances in the core and the periphery – calculated over yearly levels and absolute changes. As may be seen, the values have turned from large and negative to large and positive, possibly confirming that core (German) surpluses are now 'attracting' the current-account balances of the periphery.[6] As intra-Eurozone trade typically represents some 50% of total trade of its members, the existence of trade with third countries may weaken, but not eliminate these interactions within the Eurozone.

One wonders to what extent this may have become a structural feature of the Eurozone; for countries that cannot correct their real appreciation relative to Germany, domestic demand and output growth cannot exceed that observed in Germany without pushing the country against the balance-of-payments constraint and eliciting prompt punishment by financial markets. The ECB provision of liquidity may offer temporary respite – as it has indeed done during the Crisis (Micossi 2015a) – but it cannot remove the constraint. On this, the European Commission (2015a) notes that "the current account improvements recorded in previous years were to a large extent non-cyclical, since imports were reduced on a permanent basis as a result of reduced potential output in the non-tradable sector".

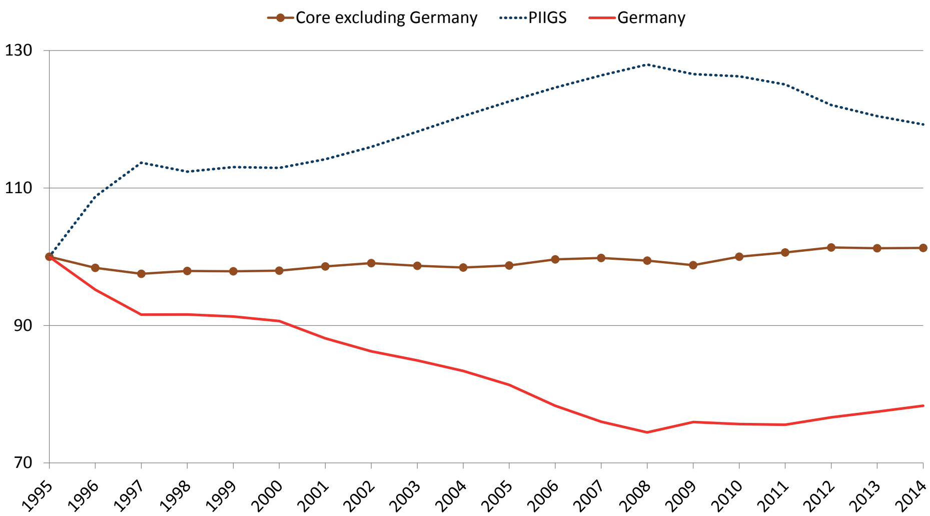
In sum, Germany has emerged as a kind of real economic anchor of the Eurozone, forcing its preference for high savings and slow growth of domestic demand onto the other members. However, this slow growth is incompatible with the need to reduce debt

6 The reversal of these correlation signs was pointed out to me by Daniel Gros. On this, the European Commission (2015a) confirms that "external rebalancing is ongoing, but progress has not yet translated into significant reduction in the stock of external debt, while large current account surpluses have not adjusted ... implying a progressive growth in the stock of their external assets" (p. 15). This remains as an important factor of financial fragility.

and reabsorb much higher unemployment and social distress. At the same time, very low inflation further compresses the margin for change in relative prices and wages.

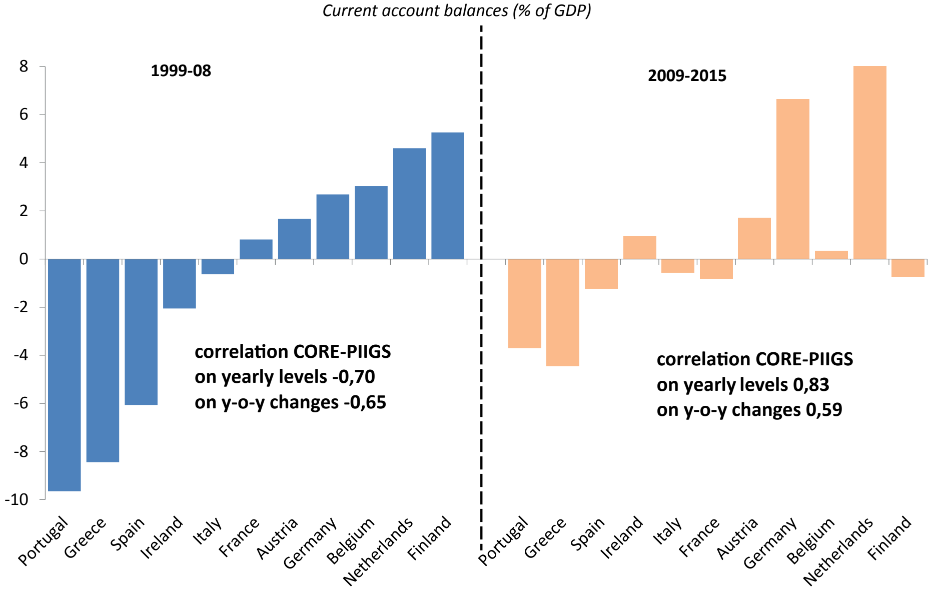
Figure 2 Real effective exchange rate, current account and domestic demand

Real effective exchange rate (1995=100)

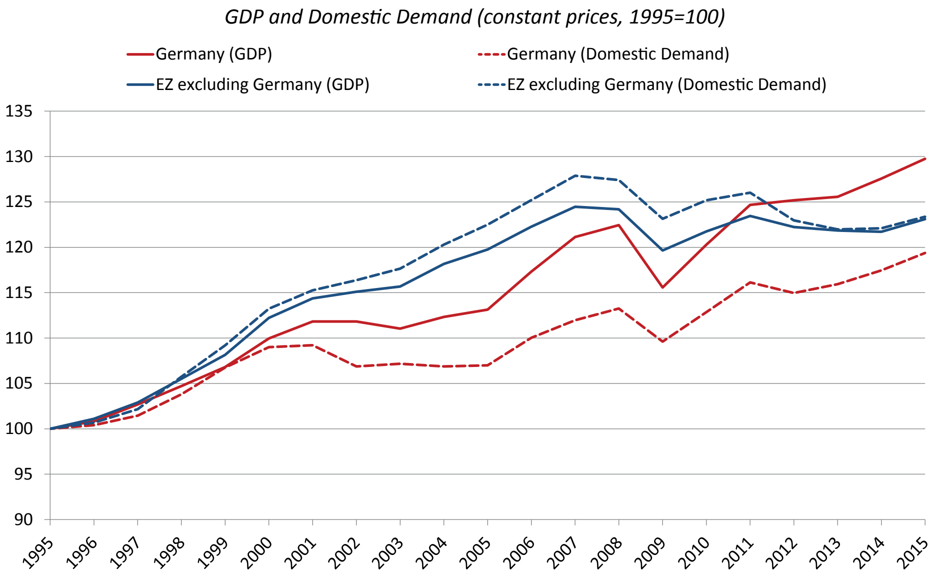


Note: REERs deflated by unit labour costs in the total economy and computed with respect to EZ 18 trading partners. CORE countries are Austria, Belgium, France, Finland and the Netherlands. Data source: Eurostat

Current account balances (% of GDP)



Source: IMF

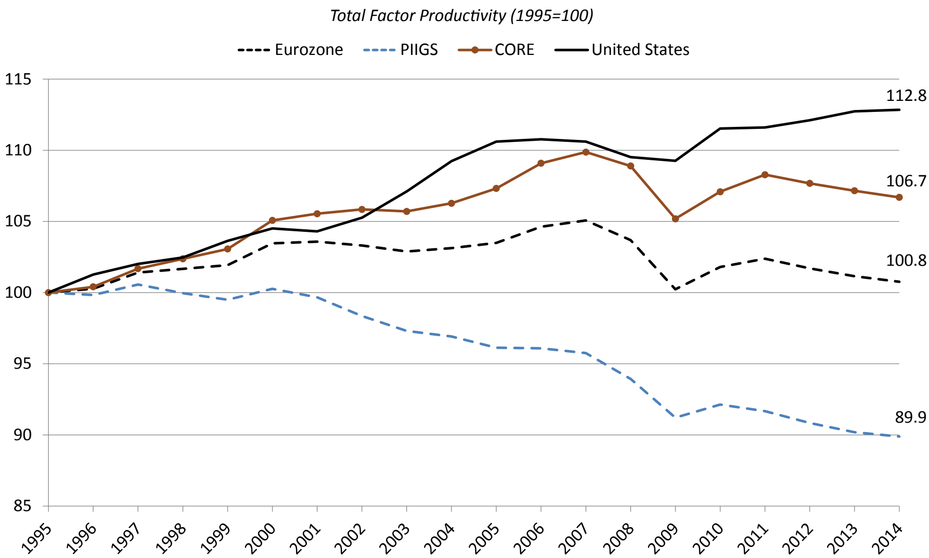


Source: Ameco

Figure 3 casts further light on the depth and persistence of the divergence in fundamentals within the Eurozone. The total factor productivity (TFP) developments are represented in the upper quadrant. As may be seen, while all Eurozone member countries fall behind the US, the inception of the euro has coincided with an adverse structural break in productivity in the periphery, with no visible sign of recovery as yet. Elsewhere (Micossi 2015b), I have argued that lax financial conditions and the shifting composition of output towards non-tradables in the periphery, linked to real exchange-rate appreciation, may help explain these developments. An indirect confirmation may be found in the data on the quality of institutions (based on World Bank indicators), depicted in the middle quadrant of Figure 2. They show, after the start of the euro, a deterioration of key institutions that are relevant for economic performance everywhere, but even more strongly in the periphery. While a drop in government effectiveness may be due to some extent to the dramatic cuts in public expenditure required by austerity, there is no reason why the preservation of the rule of law, the control of corruption or the quality of regulation should have worsened in response to the Global Crisis. A large weight in these results for the periphery is attributable to Italy.

The third quadrant of Figure 3 displays debt-to-GDP ratios for Germany, the core, and the periphery of the Eurozone. Public-debt ratios diminish in Germany and Ireland, but are still increasing in many countries.[7] For highly indebted countries, the apparent weak effect on inflation of the ECB's quantitative easing (QE) and the inability to agree on common policies capable of raising real economic growth above the current meagre numbers portends renewed financial turbulence, with smaller cushions to cope with it.

Figure 3 TFP, quality of institutions, and public debt

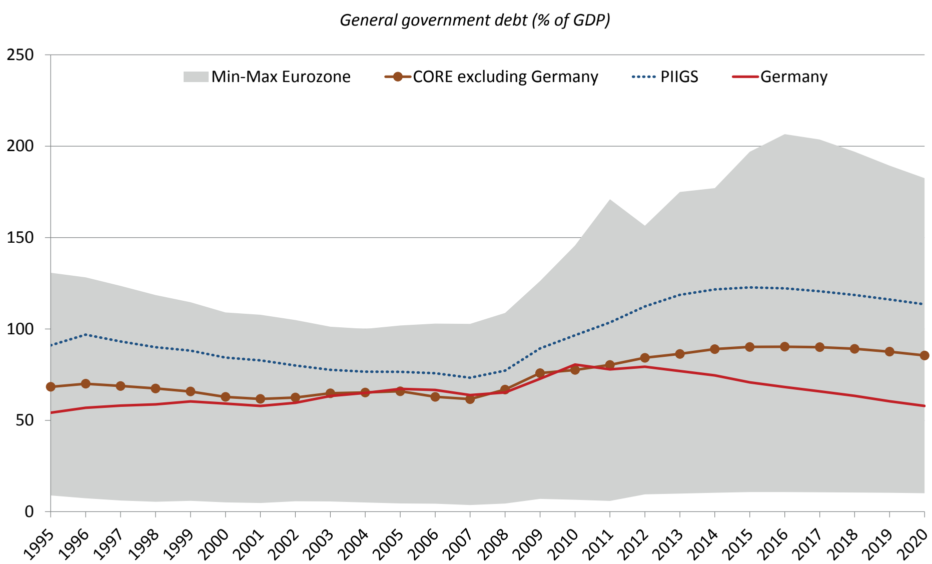


Source: Conference Board

7 Debt ratios stand above 120% in three countries (Greece, Italy, and Portugal), at 197% in Greece (where each bout of austerity has only raised the level higher, despite private creditors' write-offs of €100 billion), above 100% in Belgium and Ireland, and close to 100% in France and in Spain, where they are still rising. That Greece cannot honour these debts and that some kind of debt relief will again be required is obvious; and yet the current adjustment programme agreed with EU institutions entails a fresh cut of the public sector deficit of some 4.5 percentage points of GDP, in a country that has already lost a quarter of its output since the Global Crisis struck. This was the price to be paid to gain approval of the new rescue package in the German Bundestag, but has hardly improved the credibility and sustainability of Eurozone policies.

Note: Core are Austria, Belgium, Finland, France, Germany and Netherlands.

Source: World Bank. Our updating and reclassification of the figure from Boltho & Carlin (2012).



Source: IMF

Comparing the Eurozone with Bretton Woods exchange-rate arrangements

The Bretton Woods fixed exchange-rate system differs from the Eurozone in many important features, including the fact that the former offered a way out of parity changes when confidence problems made financial stresses unendurable, while that option does not formally exist in the latter (although the prospect of Grexit has been repeatedly invoked in the European Council in the heat of life-and-death negotiations over the Greek adjustment programme, and markets have no doubt taken notice). Moreover, in the former system, liquidity creation was in the hands of the central bank providing the reserve currency, the US dollar, while in the latter it is in the hands of an independent institution governed by a Committee (the ESCB Governing Council) deciding by consensus. Thus, the former system was open to excessive liquidity creation, which destroyed confidence and eventually broke the system (Triffin 1978, Meltzer 1991), whereas in the latter, confidence was shattered to the breaking point by the possibility that the ECB would not be allowed to intervene as a lender of last resort in distressed sovereign debt markets (De Grauwe 2013, Micossi 2015b).[8]

A feature common to the two systems is that the adjustment burden falls more on the deficit country when liquidity is scarce, and on the surplus country when liquidity is abundant (Meltzer 1991, Bordo1993). In any event, neither system has been able to establish a functioning adjustment mechanism to correct competitive imbalances based on an agreed burden-sharing between surplus and deficit countries (Bordo 2014).

But there are other features of the two systems worth comparing, notably including the balance of economic benefits from participation in the system. In this regard, a first feature to be stressed concerns the structure and evolution over time of the balance of

8 In the Eurozone, the first-line escape valve when one of its members comes under attack by financial markets is the existence of a payment clearing system, the Target system, that provides open-ended financing of payment imbalances, as long as national banks have eligible collateral to bring to the ECB. During the sovereign debt crisis, private capital flows vanished and the interbank payment system came close to collapsing. The ECB then acted to provide ample financing facilities to distressed banks, leading to the emergence of ample Target debtor and creditor balances (Bordo 2014, Sinn & Wollmershauser, 2011).

payments. In both systems the centre country displays on average a current balance-of-payments surplus; however, under Bretton Woods the surplus was shrinking over time, thus generating a positive demand stimulus for the other participants (Bordo 1993); in the Eurozone, the opposite has been true, as has been described. Moreover, under Bretton Woods the current payment surplus was offset by massive official aid flows in the 1950s (the pre-convertibility phase, up to 1958), and equally massive private direct investment flows in the 1960s (the convertibility phase).[9] These flows played a paramount role in fostering the post-war reconstruction and then rapid catching up in technology and productivity.

This contrasts sharply with the experience of the Eurozone, where direct investment by Germany in the rest of the area, and especially the periphery, has been subdued up to the Crisis, close to nil after the Crisis struck and capital markets became fragmented by vanishing confidence in the periphery. Thus, the counterparty to ballooning current surpluses was portfolio investment out of the area.[10]

Three indicators of the real economic impact of the two exchange-rate systems are presented in Figure 4 (over the respective time horizons of existence):

- In the upper quadrant, it may be seen that the real exchange rate of the centre country was always relatively more undervalued in the Eurozone than under Bretton Woods, entailing a persistently stronger competitive pressure on other participants in the system.
- In the middle quadrant, one can see that the US always maintained under Bretton Woods a negative real net trade balance (here depicted as a ratio to domestic

9 Under BW, full convertibility of national currencies into US dollars and gold for current balance-of-payments transactions was established at the end of 1958; countries maintained the right to impose restriction on capital flows, which were indeed repeatedly resorted to when pressure on existing parities built up strongly. Thus, the convertibility phase of BW lasted from the end of 1958 to the severance of the link between the US dollar and gold in August 1971, and the fixed parity system eventually broke down in early 1973 (Eichengreen, 1996; Meltzer, 1991).

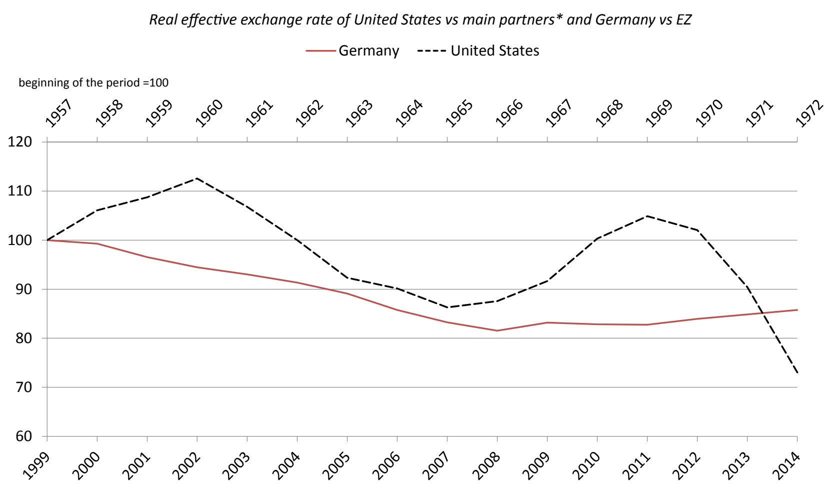
10 According to the European Commission (and other observers), these investments abroad have yielded dismal returns, also due to massive losses on derivative positions (see European Commission, 2014, Box 4.1, p. 72). Busse & Gros (2016) have challenged this view – mainly based on the observed discrepancy between the cumulated current accounts of Germany and its net international investment position (NIIP). They argue that the NIIP is incorrectly measured, while the returns on net foreign investments in the balance of payments have risen in recent years (to some [2] percent of GDP or, according to their estimates, to about 4.5% on average over the NIIP.

demand, to highlight its aggregate impact), while in Germany there has been a swelling surplus depressing demand in the rest of the area.

- In the lower quadrant, one can see the relative evolution of labour productivity in the two areas, with the US losing ground in favour of its partners throughout the existence of those arrangements, and Germany (slowly) gaining ground throughout.[11]

In sum, under Bretton Woods the US opened its domestic market to pull in net exports of their main partners, invested to improve their productivity and provided ample liquidity to facilitate the expansion of trade and the payment system. Throughout the Bretton Woods period, US domestic demand was growing buoyantly; after the mid-1960s, the appreciation of the real exchange rate of the dollar was amplifying the room for expansion in the rest of the industrialised world. Thus, altogether it comes as no surprise that the Bretton Woods system displays the best real economic performance amongst all exchange rate systems on record (Bordo 1993).

Figure 4 Real effective exchange rates, net exports, and labour productivity under Bretton Woods and in the Eurozone

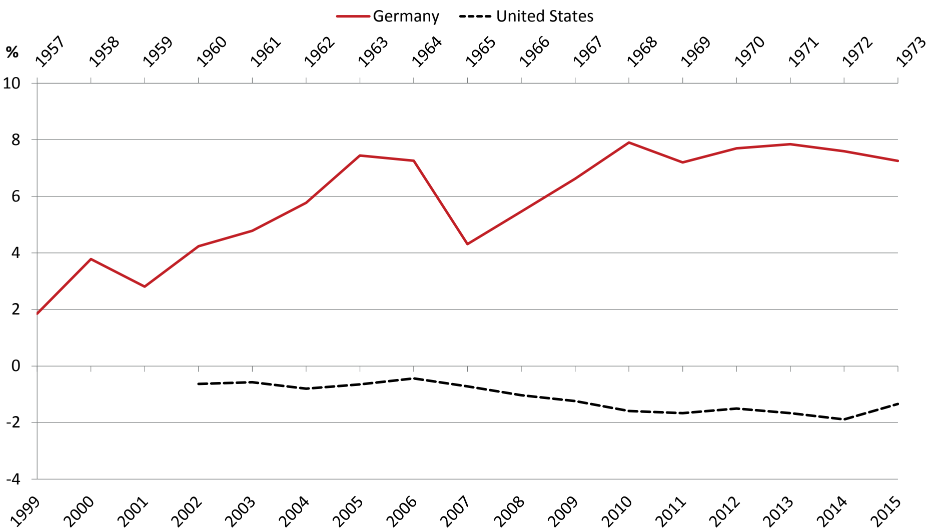


* Main partners are France, Germany, Italy, Japan, and the UK.

Source: Eurostat for Germany, relative to the rest of EZ. Bordo (1993) and US Bureau of Labor Statistics for the United States, computed as the average of main partners' bilateral real exchange rates ULC adjusted.

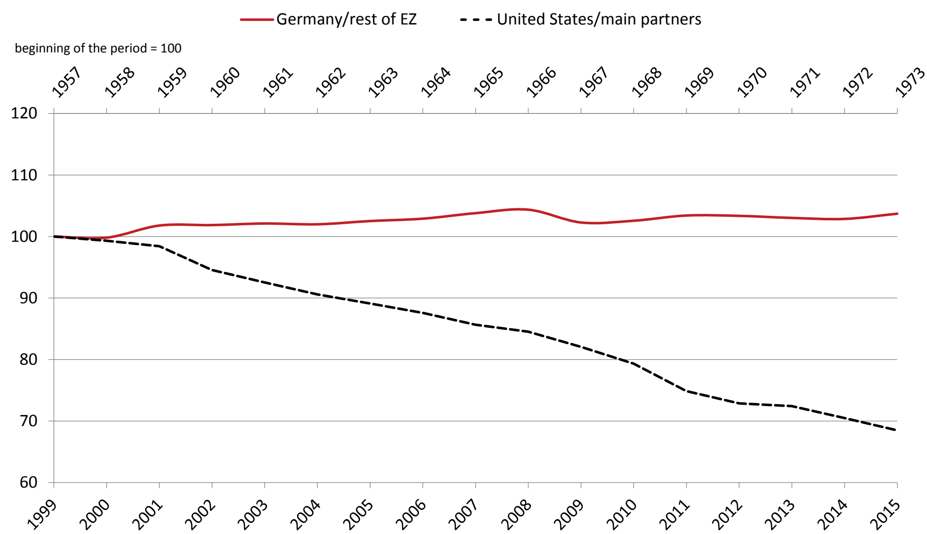
11 Conference Board data on total factor productivity are only available starting in 1990. For this reason, the comparison of productivity in the lower quadrant of Figure 4 is based on labour productivity – which amplifies the relative gains of US partners, owing to stronger labour substitution in the presence of more rapid labour cost increases relative to the US.

Share of net exports on domestic demand under Bretton Woods and the Eurozone



Source: Ameco. Constant prices

Labour productivity ratios: United States vs. main partners and Germany vs. rest of the EZ*



**Main* partners are Germany, France, Italy, Japan and the United Kingdom.

Source: Conference Board

The Eurozone, on the other hand, has been anchored to a country with stagnating or very slowly growing domestic demand, a sharply depreciated real exchange rate, and little contribution of stable long-term capital flows to the financing of the current-account deficits in the rest of the area. Total factor productivity growth has been stagnant throughout the area and there has been little market opening beyond manufacturing, the domain of the German competitive advantage. The services markets have remained closed, especially for the very important network utility services (energy, transport, and communications), which are still organised on a national basis under tight national protection (and often public ownership of service providers). This market segmentation and persistent protection of national oligopolistic structures in network services and network utilities has been consistently identified as a main factor in explaining the sizeable delays in the adoption of IT technologies and the productivity shortfalls in the Eurozone and the EU relative to the US (Timmer et al. 2010).

Concluding remarks

The evidence discussed in this note raises some questions relevant for the long-term sustainability of the Eurozone. The system seems unable to generate sufficient growth and inflation to place excessive public debt on a credible reduction path. It does not seem to have a functioning adjustment mechanism to reabsorb existing competitive imbalances;[12] their correction solely through domestic deflation policies in deficit/debtor countries would worsen an already dismal growth performance and possibly soon hit a hard wall of political and social resistance. Under these trends, one cannot exclude that at some stage a new financial shock may hit a highly indebted country – possibly when the ECB's bond-buying programme will come close to its end – while discussions on an effective risk-sharing mechanism remain stalled in a climate of deep mutual mistrust.

12 The question of external payment imbalances would in principle fall under the newly established Macro-Economic Imbalances Procedure, which however has been so far applied asymmetrically to deficit and surplus countries, with much of the adjustment pressure being placed on the former and therefore not resolving the deflationary bias implicit in the present policy coordination arrangements. In this context, Sapir and Wolff (2015) have proposed the establishment of national competitiveness councils charged with the task of monitoring nominal wage developments and ensuring that they remain in line with the requirements of external competitiveness, and the idea has been taken up by the Five Presidents Report on Economic and Monetary Union.

The Eurozone is not condemned to this doomsday scenario and could be lifted from this unsustainable path by appropriate policies, but these would require choices that its members seem at present unwilling to make.

On the one hand, it is imperative to raise the growth path of the Eurozone economy, and the ECB expansionary policies may not suffice to this end. There is an urgent need to raise public and private investment in Germany and elsewhere, to improve material and immaterial infrastructures where the European economy has been falling behind (IMF 2014). The ultra-low level of long-term interest rates offers ample opportunity to borrow and invest long-term at attractive returns. The Juncker plan (European Commission 2015b) may be of help in this regard. However, a significant increase in private investment will not be forthcoming without a major market-opening initiative by the European Council and the Commission – which brings me to the second horn of a strategy to rescue the Eurozone from its eventual demise.

The Eurozone (and the EU) needs aggressive market opening in services, which is the area where it has been systematically lagging behind the US in GDP and productivity growth, and which holds the promise of generating significant income and jobs. There is an especially urgent need to open Europe's network utility services to competition and cross-border integration, which would attract substantial private investment from all over the world for the consolidation of the fragmented and inefficient energy, transport, and communications industries in the area. Over the longer period, the Eurozone should aim to achieve a full integration of labour and capital markets, which is the only way to finally eradicate market segmentation and competitive imbalances from its economy.

All of this is predicated, of course, on the hypothesis that budgetary and structural reform policies in the Eurozone member countries will be kept on a course of improving convergence in fundamentals.

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Needed: A European institutional union

Elias Papaioannou
London Business School, CEPR, and NBER

Institutional redesign and reform are currently being debated and implemented at the EU and EZ levels. However, there is a growing institutional gap across member countries – especially between the core and periphery. This column illustrates the extent of this gap. Weak institutions have already stifled reform efforts, such as the Economic Adjustment Programs undertaken by Greece and Portugal. The success of pan-European reforms and the future of the Eurozone will require coordinated action to close this institutional gap.

The recent crisis in Europe has revealed an institutional void at the EU and the Eurozone levels. For example, at the onset of the global financial crisis in 2007-2008, the EU and the currency union lacked a centralised institution for fiscal policy coordination. Transfer and risk sharing mechanisms were almost non-existent, as the EU budget is small – approximately 1% of EU GDP. In spite of some regulatory-legislative harmonisation policies in the 2000s, the supervision of banks and other financial intermediaries differed considerably across member states and the EU and the Eurozone were far from offering unified financial services to European citizens across the border. At the same time, core EU institutions, most notably the EU Commission, were not in a position to offer leadership and coordinate the policy response to a crisis that threatened the existence of the EU. The EU Council of Heads of State and Economics and Finance Ministers (the ECOFIN/EuroGroup) responded to market turmoil sluggishly without having coherent plans. If anything, EU politicians added risk to the system (Baldwin and Giavazzi 2015, Corsetti 2015). Given these flaws and the evident institutional void, the ECB took a central role, coordinating not only monetary policy, but also pushing for the banking union project, for the establishment of transfer mechanisms (the European Stability Mechanism, ESM), and even assisting in the design of policy reforms in product and labour markets. Some have argued that the ECB is even involved in fiscal policy.

The apparent institutional void has led to some modest reform, most notably the banking union project (with a single supervisory mechanism regulating large systemic European banks, common capital requirements, and a common bank resolution system) and the creation of the ESM, which can assist member states in crisis times. And there are many proposals in the direction of more centralisation, such as launching Eurobonds, the establishment of an EU centralised fiscal authority,[1] and the empowerment of existing EU institutions, such as increasing the balance-sheet of the European Investment Bank (see Tabellini 2016). These proposals are in the right direction, though unfortunately – and in a very European manner – they move slowly and are filled with exemptions and loopholes.[2]

Institutional gaps at the national level

At the same time, there is a non-negligible gap on EU-EZ countries' national institutional capacities (quality of justice system, tax collection, administrative performance, control of corruption); this gap, which has not received much attention either from policymakers or from academics, is equally dangerous to the weak and dysfunctional pan-European institutions.

In the countries of the European core (e.g., Germany, Netherlands, Austria), legal institutions are well-functioning, adequately protecting investors from managerial fraud; property rights are well-defined; public bureaucracies are professional and public goods-provision is decent; red tape and corruption, while not absent, are not huge

1 See Sapir and Wolf (2015) and Guiso and Morelli (2014) on the European Financial Institute proposal.
2 For example the key issue of a common deposit insurance scheme has been postponed and the ESM's funds are quite small given the size of the countries in the 'danger zone' (Italy, Spain).

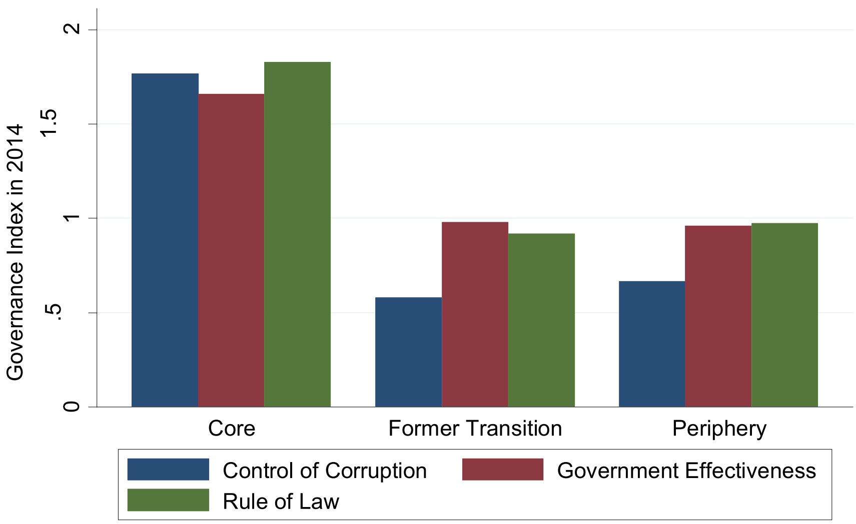
issues. While there is always room for improvement, the European countries of the core enjoy strong state capacity, being able to enforce their government's legislated policies, collect taxes, and apply the rule of law. In contrast, in the European periphery (Greece, Italy, Portugal, and Spain), legal protection of shareholders and creditors is weak, both because laws are conflicting, ill-designed and not-well-thought-out, and because courts are slow, inefficient, and often produce conflicting rulings. Public administration and national bureaucracies are largely inefficient, characterised by political interference, graft, and lack of professionalism. And states' fiscal capacity is not particularly strong, as tax evasion is sizeable and it is challenging for the government to enforce its decisions (Besley and Persson 2011). Moreover the size of the unofficial economy is considerable with sizeable costs for the state coffers and negative spillovers in the formal sector.[3]

Figure 1 below illustrates this gap using some proxies of national institutional quality from the World Bank's Governance Matters Indicators Database (Kaufman et al 2011). The graph plots the mean values of three governance quality measures (rule of law, control of corruption, and government-bureaucratic effectiveness) for seven core EZ nations (Finland, France, Luxemburg, Germany, Netherlands, Austria, and Belgium), the seven EZ periphery countries (i.e., Greece, Malta, Cyprus, Ireland, Spain, Portugal, and Italy) and the five EZ member countries in Eastern Europe that transitioned from centrally planned to market economies in the 1990s (Slovakia, Slovenia, Latvia, Estonia, and Lithuania). There is an evident gap between the core and other two sets of countries across all categories. And while these indicators are survey-based, proxies containing perhaps non-negligible noise, a similar picture emerges when considering other indicators that measure specific aspects of the institutional environment, such as legal quality, court efficiency, red tape in product markets, and easiness of registering property. In Figure 2 we tabulate the mean values of a proxy of court efficiency that measures the days needed to resolve a simple legal dispute in courts. There are sizeable

3 See the estimates in Schneider et al (2011). In a novel study that compares declared with estimated-by-banks income of professionals in Greece, Artavanis et al (2016) estimate that non-reported professionals' income in Greece was around 28 billion euros in 2009. The foregone revenue is around a third of the record-high fiscal deficit of 2009 that exceeded 15% of GDP.

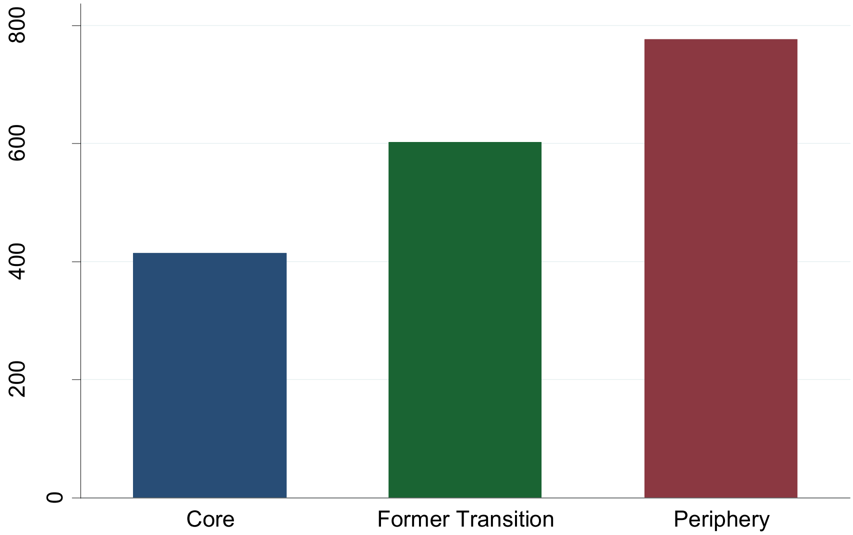
differences in court delays across the Eurozone with countries in the South (namely Greece, Italy, Portugal, Malta, and Cyprus) having formalistic and slow court systems. It takes roughly 800 days to resolve a simple commercial dispute in the countries of the European South, double the time needed in the EZ core. Data from the European Justice Scoreboard that provides a much more analytical overview of the performance of courts across Europe suggests that the problem of delays is even more pronounced when one focuses on cases pending in administrative courts; for example in Greece it takes more than three years to resolve a straightforward dispute in Greece (Papaioannou and Karatza 2016).

Figure 1 Institutional gap across the Eurozone



Source: World Bank. Governance Matters Database.

Figure 2 Court inefficiencies across the Eurozone



Source: World Bank. Doing Business around the World Database

Institutional divergence

The institutional gap across EU-EZ member states is not news and by no means a recent phenomenon. Due to historical, cultural, geographical and other deep-seated reasons, EU and EZ member countries have followed heterogeneous economic and institutional development paths.[4] Yet two aspects have not received much attention.

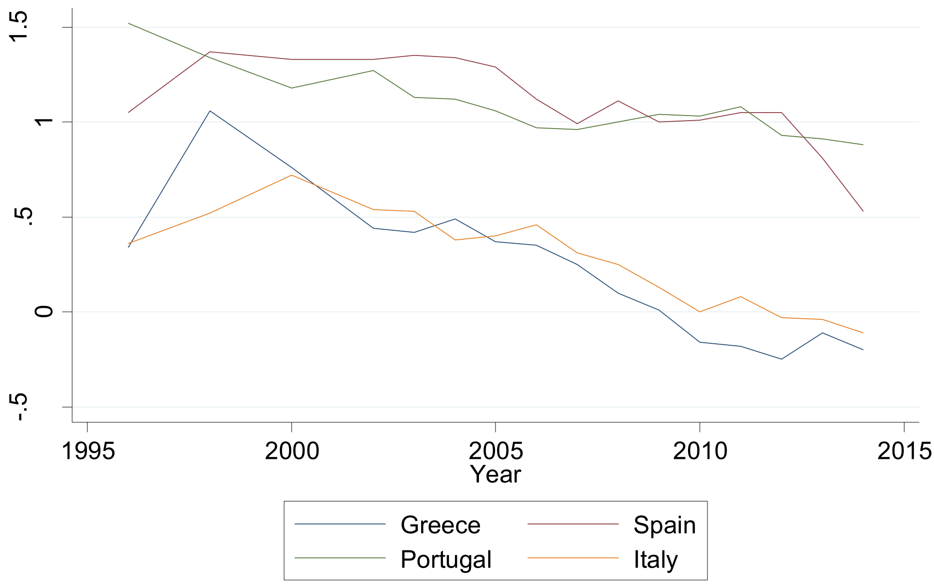
The first phase: Economic convergence without institutional convergence

During the transition period in the 1990s and during the initial years of the single currency (roughly 2000-2007), the economic convergence in the European periphery was not accompanied by any noticeable improvement in national institutions; corruption remained relatively high across most countries in the European south, legal quality even deteriorated in Italy and in Greece, tax evasion remained high, and the performance

4 See Acemoglu et al (2005) and Nunn (2014) on institutional persistence and on the historical origins of contemporary development.

of public administration and local bureaucracies remained at low levels. So while institutional and economic development usually goes in tandem (as in the case of former communist countries), this is not what we observed during 1993-2007 in the initial EZ member countries. If anything, there was a slight deterioration in institutional capacity of most countries in the periphery and across many dimensions. Figure 3 shows the evolution of the World Bank's control of corruption index in Spain, Italy, Portugal, and Greece from 1996 till 2014. After some improvement in the late 1990s, there is clear deterioration. A similar pattern emerges when one examines the evolution of the rule of law index that captures the quality of property rights and contractual institutions and the index of government effectiveness. By contrast, the control of corruption, rule of law, and government effectiveness indicators are quite stable in the countries of the core.

Figure 3 Evolution of control of corruption in the European south



Source: World Bank Governance Matters Indicators.

Institutional persistence can explain part of the continuation of the institutional gap across the EU; yet EU and EZ policies did not help. There were at least four policy mistakes:

1. To start with, the Maastricht Treaty and the Stability and Growth Pact criteria and rules that set the stage for the currency union in the 1990s focused myopically and exclusively on outcomes (e.g., inflation rates, fiscal targets) rather than on improving the associated institutional environment of members states (Papaioannou 2015). The targets were purely fiscal and monetary and there were no specific goals to improve the institutional environment of conducting business. And while in the 1990s the countries of the periphery did implement some reforms, mostly on product markets, to meet the Maastricht Treaty targets, the reform effort tuned down and eventually got abandoned when countries joined the Eurozone (see also Fernandez-Villaverde et al 2013).
2. There was not much effort by EU-EZ bodies (Commission, ECB, the European Parliament, and the Council) to improve dysfunctional institutions, even though administrative red tape, corruption, and slow courts were interacting with EU policies. For example many member-states in the South and in Eastern Europe could not fully absorb EU structural funds aiming to improve infrastructure and welfare states due to slow, inefficient, and corrupt local bureaucracies. So not only did the EU fail to set up specific institutional targets, but it did not seem to bother much, even when ineffective national institutions were impeding EU policies.
3. While institutional reform was part of the Lisbon Agenda of 2000 that aimed to make the EU “the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion”, these reforms and ideals were abandoned. The Lisbon Agenda as it stands is arguably one of the biggest EU failures.
4. At the national level, the fall in interest rates in the periphery led to capital flow bonanzas, investment spikes (mostly in non-tradeable sectors), and an associated decline in unemployment; thus the local political establishment did not prioritise institutional reform. Thus, unfortunately, the countries of the EZ periphery are forced to undertake institutional reform amidst deep recessions, something quite challenging for the political establishment.

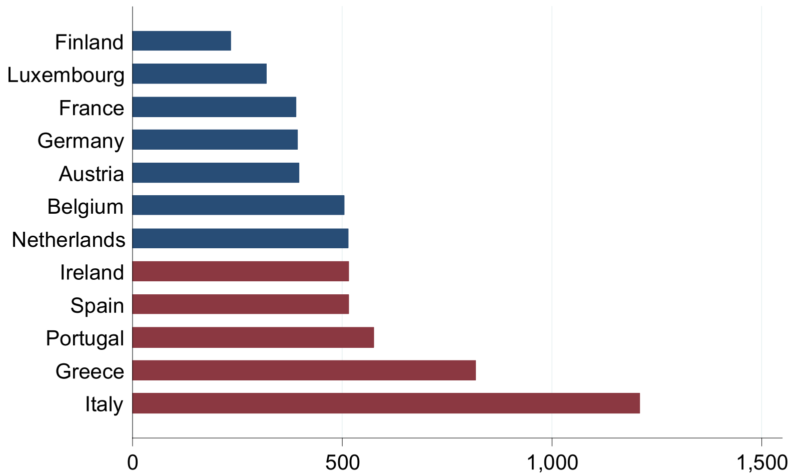
The crisis and institutional divergence

The crisis uncovered the institutional deficiencies of the European periphery that somehow were hidden by the robust foreign-capital-driven growth of Greece, Ireland, Spain, and Portugal in the period 2000-2007. As the crisis intensified and countries demanded huge external financial support packages, attention shifted to growth prospects, as this is a crucial element in any debt sustainability analysis. The market's focus was on tax evasion and the size of the shadow economy, as they matter crucially for debt sustainability.[5] EU and national policymakers started delving into the institutional details as it became apparent that tackling corruption, improving public administration, reforming legal protection of investors, and speeding-up the judicial process were necessary conditions for a recovery.

Figure 4a shows the sizeable differences in courts' delays at the beginning of the crisis between core countries (in blue bars) and periphery countries (in red bars). There are massive delays in Italy and Greece, with Portugal, Spain, and Ireland following. Yet, as Figure 4b that plots the data in 2014 illustrates, things have not improved. Actually the situation in Greece has deteriorated sharply due to the interactive effects of the deep recession that increased incoming cases and troika's policy to lowered courts' funding and cut judges' compensation. The same applies when one looks at courts' ability to deal with bankruptcy and insolvency. World Bank's Doing Business around the World Statistics show that the time spent in bankruptcy in Greece has increased from roughly 2 years (in 2008) to 3.5 years (in 2014), while mean recovery rates have fallen from 46% to 34%.

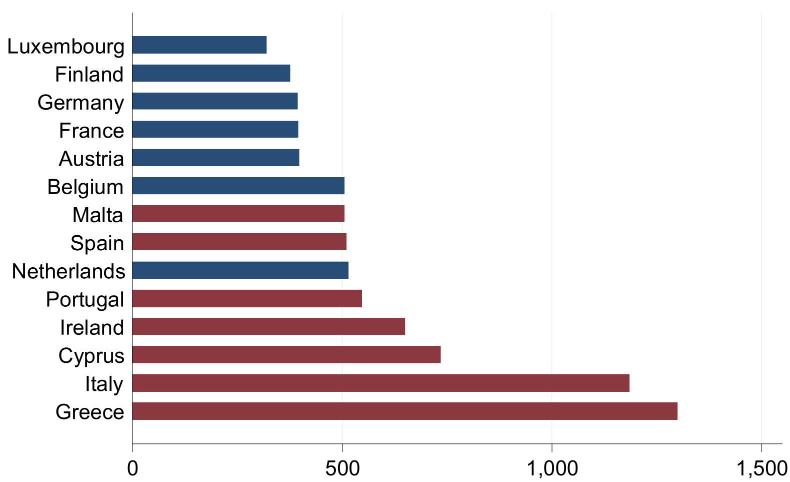
5 See Markellos et al (2016) for the role of the informal sector and the shadow economy on sovereign debt markets.

Figure 4a Courts' inefficiencies (delays) in 2008: Number of days to resolve in courts a simple dispute



Source: World Bank. Doing Business around the World Database.

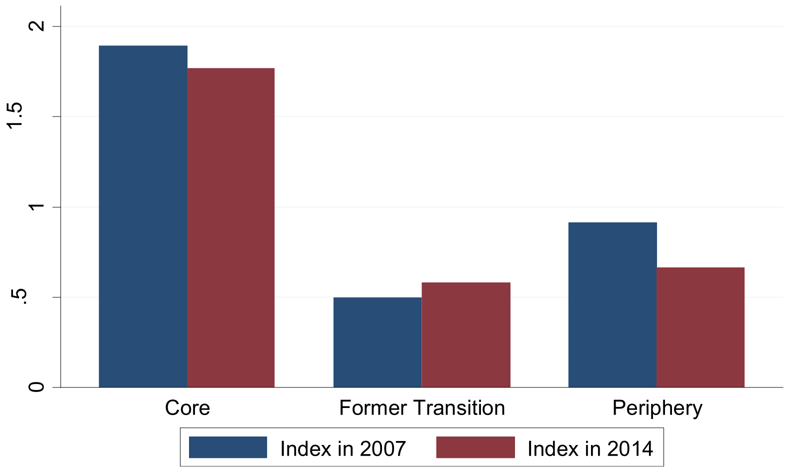
Figure 4b Courts' inefficiencies (delays) in 2008: Number of days to resolve in courts a simple dispute



Source: World Bank. Doing Business around the World Database.

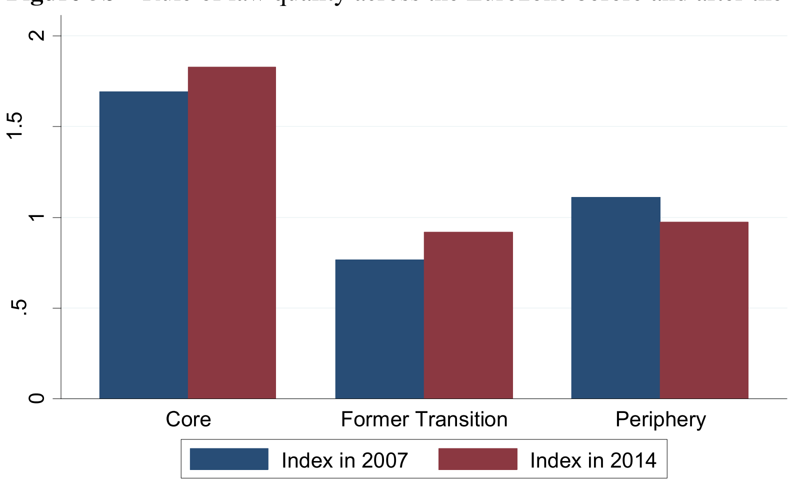
This pattern of institutional deterioration in the European South over the crisis years applies when one looks at other indicators capturing distinct (though related) aspects of local institutional capacity. For example, Figures 5a-5b tabulate the mean values of the control of corruption and rule of law indicators in 2007 and in 2014 for the three EZ group countries – core, periphery, and former transition.

Figure 5a Control of corruption across the Eurozone before and after the crisis



Source: World Bank. Governance Matters Database.

Figure 5b Rule of law quality across the Eurozone before and after the Crisis



Source: World Bank. Governance Matters Database.

Arkolakis et al (2016) provide further evidence of a deterioration of the institutional environment in Greece and other countries of the European periphery during the crisis. For example the ranking of Greece in the rankings of the Global Competitiveness

Indicators of the World Economic Forum has fallen from 67 (out of 134 countries) in 2008-2009 to 91 (out of 148 countries) in 2013-2014. The drop is especially pronounced in the 'institutions' subcategory were Greece's rank fell from 58 to 103.

Consequences of institutional gap and divergence

The apparent and growing institutional gap between the core and periphery (and also the former communist countries) has important implications for the functioning of the EU and the Eurozone for at least two reasons.

First, the institutional gap maps into non-negligible differences in output, productivity, labour utilisation, and unemployment, between the core and periphery. A voluminous theoretical and empirical literature provides ample evidence that institutional quality – namely sound investor's protection, efficient judicial processes and courts, absence of red tape, control of corruption, and state capacity to enforce contracts and collect taxes – matter crucially for productivity (see for an overview Acemoglu et al 2005, Acemoglu and Robinson 2012, Besley and Persson 2012, La Porta et al 1997, 1998, Djankov et al 2003). The resulting gap in economic performance has contributed to the large European balance of payment imbalances (trade deficits in the periphery financed with capital from banks in the core), which have been a key driving force of the crisis (Baldwin and Giavazzi 2015).[6] One should stress here that research shows that institutions are crucial for total factor productivity ('new growth-style') growth, as they are disproportionally more important for exports, entrepreneurship, innovation, and the process of creative destruction. It is no coincidence that the severity of the crisis and length of the economic downturn map almost one-to-one to institutional deficiencies and the associated current account deficits in the beginning of the crisis (see also Micossi 2016).

6 See Arkolakis et al (2016) for the link between economic institutions, trade deficits, and misallocation, focusing on Greece.

Second, malfunctioning national institutions in many EU-EZ countries and the resulting institutional heterogeneity impede the conduct of EU-EZ policies, as their implementation depends on local institutional structures and member countries' state capacity. For example, the enforcement of EU legislation (EU Directives and EU Regulations) on a variety of issues, related to product markets, financial intermediation, industrial policy, depends on national courts, parliamentary acts, and administrative actions. Another example of how failing national institutions block EU-EZ reforms comes from the Economic Adjustment Programs (EAP) that Greece, Ireland, and Portugal had to undertake as well as the strict EU policy guidelines in Italy and Spain. Many provisions and policies detailed in the EAPs on strengthening tax collection mechanisms, reducing red tape for businesses and entrepreneurs depend crucially on local public administration, courts, and state ability to convert wills and laws into action. So the partial – at best – success of those programs should not be surprising, as they initially just set some fiscal and economic targets without delving into the institutional frictions. Greece's initial EAP in the spring of 2010 is perhaps the most illustrative example of a program based on nominal targets that would be met with salary and pension cuts, tax hikes, and public expenditure freezes that ignored the malfunctioning Greek courts and inefficient public administration. As the IMF (2013) acknowledged in its self-assessment of the Greek program, a key policy mistake was to overestimate the country's state capacity to enforce legislation.

An example: Dealing with private debt

It has become apparent that the Eurozone has to deal with the large stock of private debt that increased considerably in the euphoria years before the crisis (CEPR 2014).[7] Dealing with the private sector's debt (households, corporates) is crucial as many firms are faced with a debt overhang issue that drags investment. Moreover, European banks seem to hold large amounts of non-performing loans on the books and resolving this

7 See Liu and Rosenberg (2013) and Buttiglione et al (2014) for an overview and some descriptive evidence.

issue is desperately needed in some countries – most notably Greece (but also Italy) – where banks have stopped lending to new firms and entrepreneurs. There are now calls to EU-EZ institutions to design pan-European policies and plans to deal with private debt and promote restructuring-reprofiling. Yet what is well-understood is that the success of any European-wide plan and regulation dealing with private debt will depend not so much on the design but on its enforcement by EU-EZ member states' insolvency and bankruptcy institutions. As Figure 6 shows there is massive heterogeneity on the performance of bankruptcy and insolvency practices across the EU and the Eurozone. In Greece dealing with bankruptcy takes more than 3.5 years and quite often more than 6 years (Papaioannou and Karatza 2016) and recovery rates are well below 40 cents on the euro. Time spent in bankruptcy is high and recovery rates are also low in Malta, France, and Luxemburg. The scatter-plot illustrates that with the exception of Ireland where the process is fast and the cost low, all countries of the EZ periphery (and all countries of the European South) are on the bottom-right of the figure with slow and inefficient processes. Moreover, in many countries, insolvency is dealt-with by professionals and specialised judges, while in other countries there are no specialised procedures. And in many nations, mostly in the North, the focus is on reorganisation and restructuring, while in most countries in the South the bankruptcy code is focused on liquidation. Given those large differences in bankruptcy and insolvency practices around the Eurozone, it is hard to see how a common policy can succeed across member states. If Europe is to deal with the perils of private debt, it needs to move beyond EU Directives and/or Regulations; it is vital to reform the anachronistic, formalistic, and in many cases absurdly slow legal institutions in the South (and also in France and Luxemburg).

Figure 6 Bankruptcy-insolvency practices across the Eurozone

Source: World Bank. Doing Business around the World Database.

The way forward

Institutional reform at the EU-EZ level and institutional convergence towards best-practices should be at the top of the priority list of European leaders and policymakers. Institutional change at both the EU and the national level is desperately needed, if Europe is to meet the growing challenges faced by globalisation (competition from industrial and emerging markets, migration), avoid destruction, and fulfil the needs and aspirations of its citizens. While institutional redesign and reform at the EU-EZ level are currently implemented and debated, there is not much discussion and action on designing a concrete, thorough, and ambitious plan of improving national institutions so as to close the persistent and, if anything, growing institutional gap across the EU and the EZ. This has to change. In this regard the EU-EZ should consider the following:

- To begin with, the EU needs to set a clear, ambitious, and succinct program aiming to address the large institutional differences across the EU, focused on improving governance, promoting growth, and raising equity.

- Consider establishing a European-level Institute that will monitor institutional performance and state capacity across the EU and the Eurozone.[8] This Institute should produce league tables and thorough statistics measuring institutional capacity and reforms in a wide range of areas, such as product markets, regulation, state administration, courts, etc. The European Justice Scoreboard can serve as a starting point, though the analysis has to be more far-reaching and in-depth. This Institute should produce annual reports that should be submitted to the European Parliament, National Parliaments, and the Council of Heads of State.

- EU structural funds – and even subsidies in agriculture – should be linked to well-defined reforms of national institutions. The current system, where the EU finances infrastructure projects mostly in Southern and Eastern Europe (that are plagued by corruption) is a disgrace; and it contributes to the rising distrust of citizens towards Europe.

- Likewise, any debt forgiveness and reprofiling (in Greece or elsewhere) should be linked to countries meeting well-defined targets on improving legal protection of shareholders and creditors, removing administrative barriers to entry, reducing legal formalism, and safeguarding the independence of public administration.

- The EU should even consider altogether blocking transfers to member states when national governments do not safeguard basic EU liberties and values, such as interfering with the independence of the judiciary or other independent national agencies.

- The EU should offer direct technical and financial assistance to member states in improving the functioning of public administration and courts. After identifying best-practices across the EU and with the assistance of the Institute, the EU could

8 In principle the EU Commission could undertake this responsibility, perhaps establishing a new Directorate. Yet currently the Commission lacks vision and necessary capacity to undertake this goal.

assist in the transfer of knowhow, covering all the expenses.

- Currently there is little – if any – coordination between the European and the National Parliaments, and the power is mostly in the hands of the executive branch of the EU, the Commission, and the Council. Perhaps the EU Parliament can get a more active role in promoting institutional reform across EU-EZ member states.

One could clearly come up with additional proposals. Yet it is of utmost importance for Europe to address the institutional gap – citizens are becoming quite distrustful towards the EU as well as local institutions, courts, political parties, and politicians. And this distrust is also quite heterogeneous, with much higher levels in the South than in the core.[9]

Conclusion

It is hard to imagine an 'ever closer union' in Europe with the currently large institutional gap in courts, public administration, red tape, corruption, and fiscal capacity. The asymmetries in national institutions across the Eurozone are destabilising both because they impede real economic convergence and because EU-EZ policies' depend crucially on local institutional structures, disparities and imbalances.

Referring to the adjustment program of Greece and the slow progress in reforms, the German Finance Minister Wolfgang Schäuble recently (January 2016) said to the Greek Prime Minister "It is the implementation, stupid!" He and his colleagues should not be mistaken, though; policy implementation depends, more than anything else, on sound institutions. And Europe has done little to assist Greece and the other countries of the EZ periphery to reform their malfunctioning institutions. "It's the institutions, stupid!"

9 See Papaioannou (2014), Guiso et al (2016), and Guiso et al (2016) on the European trust crisis and the link between heterogeneity in beliefs and institutional divergence.

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Part 5

Dealing with legacy debt

The way forward: Coping with the insolvency risk of member states and giving teeth to the European Semester

Peter Bofinger
University of Wuerzburg, German Council of Economic Experts and CEPR

The Eurozone is more crisis-prone than other major currency areas. This column suggests that due to its hybrid structure, the EZ is likely to remain crisis-prone in the near future. A main challenge is the specific insolvency risk to which the member states are exposed, which in the longer term it can only be eliminated by some form of debt mutualisation. Another challenge is that the EZ suffers from an insufficient coordination of fiscal policies and wage trends.

The experience of the last 16 years shows that EZ is a more crisis-prone regime than other major currency areas like the US, Japan, or the UK. This is mainly due to its *hybrid institutional architecture* which relies on intergovernmental and supranational elements. While monetary policy is fully integrated under the aegis of the ECB, 19 national governments are responsible for the EZ's fiscal policy. In addition, labour markets remain segmented as wage bargaining processes and labour market regulations are still organised at the national level.

'Design failures' or 'unfinished building'?

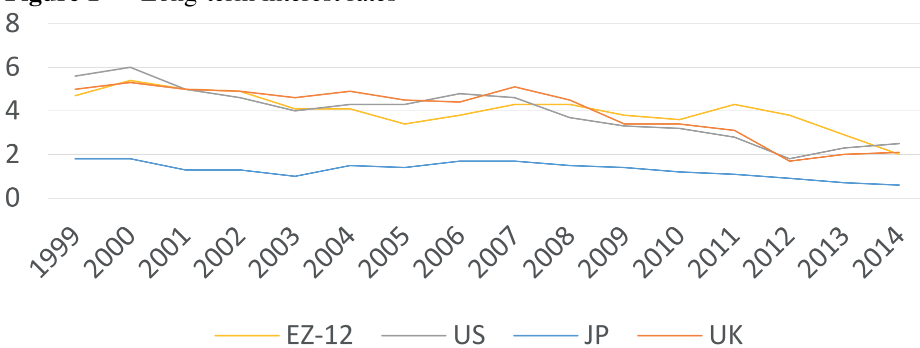
These are not necessarily 'design failures' (de Grauwe 2015). Instead, the EZ can be regarded as an *unfinished building* that needs to be completed with more coordination and more political integration. In fact, the banking union shows more stability can be achieved by increasing the supranational elements.

Solutions to the specific insolvency risk of EZ member states

The hybrid nature of the EZ is a major source for its dismal economic performance. It exposes its members to an *insolvency risk* which is absent for comparable countries. EZ membership implies that government debt is denominated in euro, while the national central bank is not able to print this currency ('original sin').[1] With the EZ crisis financial markets became aware of this risk, so that some member states lost market access and others (Italy and Spain) were confronted with very high risk premia.

This intensified the recession in the EZ. *Long-term interest rates* increased in 2011 (Figure 1), while they declined in Japan, the UK, and the US (G3). Growing market pressure also limited the room for manoeuvre in *fiscal policy*. Compared to the G3, the EZ's initial budgetary response to the Great Recession was very limited and the crisis required premature consolidation attempts in 2011/12 (Figure 2).

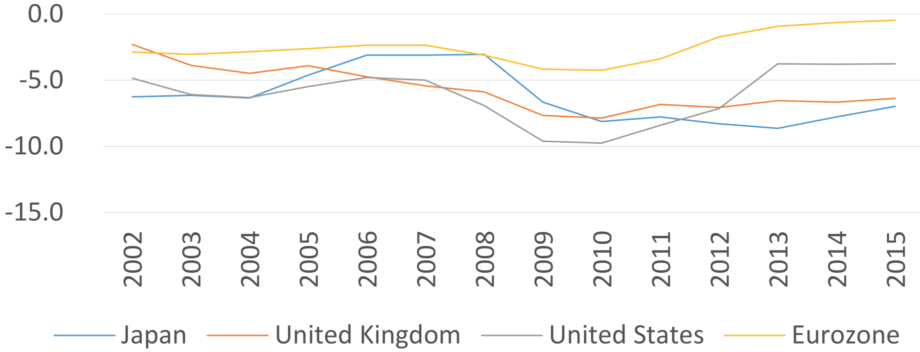
Figure 1 Long-term interest rates



Source: European Economy, Statistical Annex Autumn 2015

1 German Council of Economic Experts (2011, para. 144).

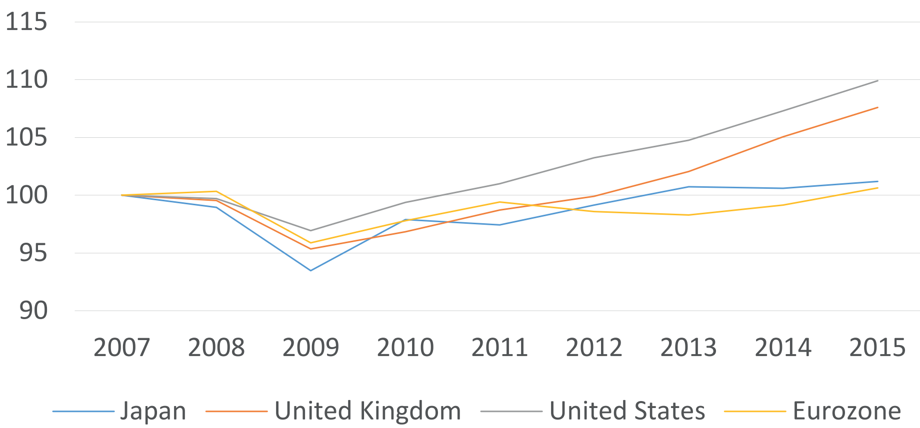
Figure 2 General government underlying fiscal balances



Source: OECD, Economic Outlook 98 database. The underlying balances are adjusted for the cycle and for one-offs.

As a result, from 2007 until 2013 GDP growth in the EZ was much weaker than in the G3 (Figure 3). The improvement that has taken place since is mainly due to the *implicit regime change* by Mario Draghi's convincing statement from 26 July 2012 to do "whatever it takes to preserve the Euro" and the ECB's announcement of Outright Monetary Transactions (OMT). This has fundamentally changed investors' perception of the insolvency risk. Under this monetary umbrella member states were no longer forced to reduce deficits at any price. Since 2013 consolidation in the EZ has come to a halt.

Figure 3 GDP developments since 2007



Source: OECD, Economic Outlook 98 Database

- The main lesson that can be drawn from the aggravation of the Crisis until July 2012 and the significant improvement after the implicit regime change is that a monetary union where each country is exposed to financial markets without a supranational backstop is not viable.

In such a 'gold standard without gold' (Blyth 2013, p. 184) financial markets "can force countries into a bad equilibrium characterised by increasing interest rates that trigger excessive austerity measures, which in turn lead to a deflationary spiral that aggravates the fiscal crisis." (De Grauwe 2015).

This diagnosis can lead to *two different solutions*. Some economists believe that the insolvency risk is unavoidable. Therefore, institutional procedures should be developed for dealing with future insolvencies. The alternative approach is to reduce or even eliminate the insolvency risk of member states by strengthening the supranational features of the EZ.

Preparing for insolvency by an insolvency regime for sovereigns

The majority of the German Council of Economic Experts proposes a formal *insolvency mechanism* for sovereigns. The authors argue that this would help to stabilise the architecture of the EZ.

"At times of great uncertainty, there is a risk of severe, even excessive financial market reactions that create multiple equilibria in a self-fulfilling prophecy. An insolvency mechanism for countries stabilises the expectations of market participants, which contains such effects". (GCEE 2015a, para. 47).

However, in a special report on the EZ crisis the authors explicitly acknowledge the destabilising effects of such a regime change: "The mere announcement of an insolvency regime could cause considerable turbulence on the financial markets, which makes its introduction impractical at this time." (GCEE 2015b, para. 87).

A comparison with the US indicates that a formal insolvency mechanism for EZ sovereigns goes into the wrong direction. Even for the US states no bankruptcy mechanism exists because they are considered sovereign. In addition, the main task of macroeconomic stabilisation is executed at the federal level. So far, nobody has seriously considered introducing a formal insolvency regime for the US Federal Government.

The Great Recession shows that high government deficits can be required to deal with serious demand shocks (Figure 2). After the introduction of a formal insolvency regime EZ member states with high debt levels might no longer be able to stabilise their economies effectively. With a passive fiscal policy or even a bankruptcy of the government a Great Recession could turn into a Great Depression.

Coping with the insolvency risk by debt mutualisation

The only way to deal with the insolvency risk is therefore not to prepare for a hard landing, but to find solutions that reduce or even eliminate it. The ECB's pragmatic OMT approach has been a very effective emergency solution. And for the time being it will remain the only way for coping with this risk. However, it is dangerous to rely on this informal stabilisation device as a permanent solution. For instance, it is not certain that the mandate of the ECB would make it possible to support Italy in a severe crisis of confidence.

Therefore, a stable architecture of the EZ requires some form of *debt mutualisation*, which would protect member states against bad equilibria. Prominent proposals are the 'Debt Redemption Fund' (DRF) by the German Council of Economic Experts (2011) and the 'Blue Bond Proposal' (BBP) by von Weizsäcker and Delpla (2010). The two models are complements. While the Bond Proposal entails a pooling of sovereign debt up to a level of 60% of GDP, the Debt Redemption envisages a pooling of debt exceeding the 60% threshold.

Both schemes imply a very high amount of joint debt. The Blue Bond would lead to a pool of 6.4 trillion euro, the Redemption Fund to a pool of 3.6 trillion euro (Table 1). For the time being such a high amount of debt mutualisation seems politically very difficult to achieve. At least it would require major steps towards political integration. A specific problem of the Redemption Fund is the disproportionate share of member states in southern Europe that would by far exceed their share in the EZ's GDP.

Table 1 Schemes for debt mutualisation in the EZ

	Debt Redemption Fund (Mutualisation of debt exceeding 60 % of GDP)		**Blue Bond Proposal** (mutualisation of debt which equals up to 60 % of GDP)		**Monetary Policy Bonds** (approx. 10 % GDP)	
DRF	Absolute Amount (Euro)	Share (%)	Absolute Amount (Euro)	Share (%)	Absolute amount (Euro)	Share (%)
BE	197.6	5.5	251.8	3.9	43.2	3.9
DE	266.0	7.5	1,877.4	29.3	321.8	29.3
EE		0.0	13.0	0.2	2.2	0.2
IE	77.0	2.2	130.6	2.0	22.4	2.0
EL	240.3	6.7	103.2	1.6	17.7	1.6
ES	462.6	13.0	672.0	10.5	115.2	10.5
FR	825.5	23.1	1,335.0	20.8	228.9	20.8
IT	1,209.4	33.9	1,005.0	15.7	172.3	15.7
CY	6.9	0.2	10.7	0.2	1.8	0.2
LV		0.0	15.5	0.2	2.7	0.2
LT		0.0	22.9	0.4	3.9	0.4
LU		0.0	31.6	0.5	5.4	0.5
MT	0.3	0.0	5.4	0.1	0.9	0.1
NL	55.9	1.6	424.3	6.6	72.7	6.6
AT	89.0	2.5	207.7	3.2	35.6	3.2
PT	119.2	3.3	110.6	1.7	19.0	1.7
SI	8.3	0.2	23.9	0.4	4.1	0.4
SK		0.0	48.7	0.8	8.3	0.8
FI	9.6	0.3	127.5	2.0	21.9	2.0
Sum	3,567.4	100.0	6,416.5	100.0	1,100.0	100.0

Given these constraints a scheme with relatively *limited amount of mutualisation*, e.g. in the order of magnitude of 10% of the EZ's GDP might be considered.[2] This would

2 A similar proposal was made by the Expert Group on Debt Redemption Fund and Eurobills (2014), which proposed a size of 20% of EZ GDP.

correspond with the asset purchase programme (APP) of the ECB for which a volume of about 1.1 trillion euro is envisaged. As in the Blue Bond Proposal, the share of each member should be determined by its GDP share. Such 'monetary policy bonds' would create a pool of absolutely safe assets which would facilitate open market operations. Due to the limited size, the moral hazard problems seem to be less pronounced so that no additional political integration might be required.

If the scheme is set up in the form of an international treaty, a change of the EU Treaty might not be necessary. In addition, if its size is clearly determined, it would be also compatible with the requirements laid down by the German Constitutional Court in its decision on the European Stability Mechanism (BVerfG, Urteil des Zweiten Senats vom 18 März 2014 - 2 BvE 6/12 - Rn. 1-245).

Giving teeth to the European semester

A second major flaw of the EZ is the lack of coordination of fiscal policies and wage developments. These problems were already identified in the Delors Report (1989, p.19):

> *"(...) the fact that the centrally managed Community budget is likely to remain a very small part of total public sector spending and that much of this budget will not be available for cyclical adjustments will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the coordination of national budgetary policies. Without such coordination it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance (...)."*

"As regards wage formation (…), the autonomous negotiating process would need to be preserved, but efforts would have to be made to convince European management and labour of the advantages of gearing wage policies largely to improvements in productivity." (p. 20).

Making fiscal policy coordination more effective

The absence of fiscal policy coordination is indicated by the very weak fiscal policy response of the EZ in the years 2009/2010 and the premature consolidation in 2012/2013 (Figure 2).

The *European semester* which was introduced in 2011 could be an ideal framework for fiscal policy coordination. But so far it has been a complete failure. The country-specific recommendations (CSR) are extremely vague. In 2014 they called for "a coherent and growth-friendly fiscal stance across the euro area", in 2015 for an "aggregate euro area fiscal stance (…) in line with sustainability risks and cyclical conditions."[3,4] No attempt was made to translate the aggregate picture into specific recommendations for the member states.[5]

The coordination process could be considerably improved if the recommendations define a *concrete value for the aggregate fiscal policy stance*. Based on this aggregate fiscal policy stance, specific target values for the structural budget balance of each member state should be derived taking into account the differences in fiscal space. In the case of a severe crisis like the Great Recession additional fiscal space could be created by increasing the ceiling for debt mutualisation if such a scheme was be already in place.

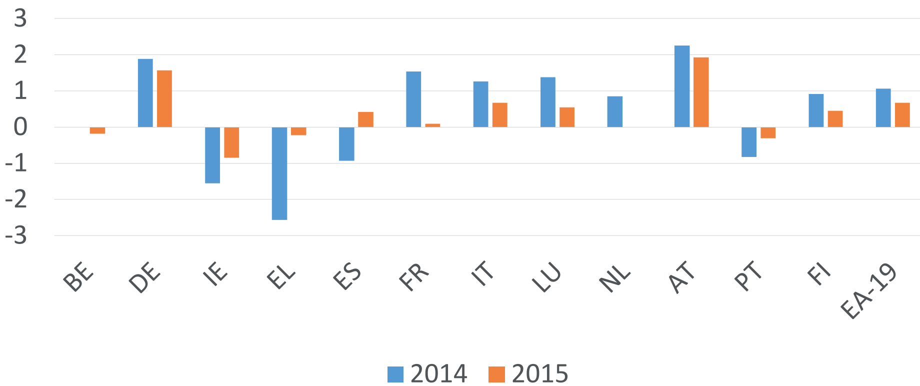
Avoiding asymmetric wage adjustments

National wage developments are another area where coordination is virtually absent. The German wage moderation of the years 2000-2007 created serious imbalances (Bofinger 2015). Today, the member states with high unemployment also try to improve their competitiveness by wage moderation. However, in Germany wage setting

3 Council Recommendation (2014/C 247/27)
4 Council Recommendation (2015/C 272/26)
5 The short-comings of the Semester were criticised by several economist (Darvas and Leandro 2015, Bénassy-Quéré 2015, Bofinger 2014).

processes do not take into account the *need for a symmetric adjustment*. As a general principle, the average increase of unit labour costs in the EZ should be in line with the ECB's inflation target. However, the average increase in unit labours costs was only 0.7 % in 2015, which can be regarded as a main cause for the low EZ core inflation rate (Figure 4).

Figure 4 Unit labour costs



Source: European Economy, Statistical Annex.

In a zero interest rate environment it is difficult for the ECB to combat deflationary trends. Therefore a symmetric wage adjustment would provide a more effective solution. It implies higher wage increases in Germany leading to unit labour cost increases above the 2% threshold, at least for some years.

Again, the European semester and the country-specific recommendations could deal with such an asymmetry. However, the asymmetry problem is not addressed at all. The country-specific recommendations for Germany even call for "measures to reduce high labour taxes and social security contributions." Such internal devaluation would make it even more difficult for the other member states to improve their price competitiveness. Thus, in the area of wages the country-specific recommendations are not only ineffective but even *counterproductive*.

Summary

Due to its hybrid structure the EZ will remain more crisis-prone than other major currency areas. A main challenge is the specific insolvency risk to which the member states are exposed. A formal insolvency regime would intensify this risk instead of mitigating it. With the OMT programme the ECB has provided a pragmatic and so far effective protection against this risk. But in the longer-term it can only be eliminated by some form of debt mutualisation. Schemes with large pools of joint debt would be met with strong political resistance and they would require more political integration. Therefore, as a first step, a mutualisation of debt amounting to 10% of the EZ GDP should be envisaged. This would create safe assets of about 1.1 trillion euro that correspond with the volume of the EZ's asset purchase programme and facilitate open market operations.

In addition, the EZ suffers from an insufficient coordination of fiscal policies and wage trends. So far the European semester has been a complete failure. Its recommendations for fiscal policy are too vague at the aggregate level and no attempts are made to translate them into specific recommendations for national fiscal policies. Wage developments in the EZ suffer from an asymmetric adjustment. As a consequence, the aggregate increase in unit labour costs is incompatible with the ECB's inflation target. In the country-specific recommendations this asymmetry is not addressed at all. Thus, the European semester needs a much stronger focus on the task of coordinating national fiscal policies and wage trends. A better coordination in these areas would lead to more symmetric and more balanced developments in the EZ. This would reduce the need for monetary policy stimulation and avoid the negative side-effects that are associated with such an overburdening of the ECB.

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Epilogue

Epilogue: Future history – how the crisis might have been handled

How the Euro Crisis was successfully resolved

Barry Eichengreen and Charles Wyplosz
University of California Berkeley and CEPR; The Graduate Institute and CEPR

When the newly elected Greek government of George Papandreou revealed that its predecessor had doctored the books, financial markets reacted violently. This column discusses the steps implemented by policymakers following this episode, which were essential in resolving the Crisis. What is remarkable, in hindsight, is the combination of pragmatism and reasoning based on sound economic principles displayed by European leaders. Instead of finger pointing, they acknowledged that they were collectively responsible for the Crisis.

Now that the Crisis has long since passed, it is easy to forget how close the Eurozone came to a disaster. When the newly elected Greek government of George Papandreou revealed that its predecessor had doctored the books, financial markets reacted violently. While Greek, Portuguese, and Italian government bonds had been good investments so long as spreads on these assets continued to converge toward those on German bunds, Papandreou's revelation was a reminder that such convergence was no certainty.

Recognising Greece's unsustainable debt

What happened next – a set of decisive steps that quickly resolved the Crisis – was nothing short of a miracle, made possible by a combination of steely resolve and economic common sense. In their historic 11 February 2010 statement, European heads of state and government acknowledged that the Greek government's debt was unsustainable. Rather than 'extend and pretend', they faced reality. Lending Greece even more money would only render it even more heavily indebted and force it to undertake an even more draconian fiscal consolidation in order to maintain the fiction that it could pay back what it borrowed. In any case, there could be no bailout of the Greek government, given the Maastricht Treaty's prohibition of such measures. Greece, European leaders insisted, had to restructure its debt as a condition of external assistance.

To be sure, the market reaction was not favourable, and not all politicians agreed. Spreads on Greek public debt, which had been minimal as long as markets anticipated a bailout, widened further. Papandreou placed urgent calls to European heads of state and to Jean-Claude Trichet, President of the ECB. Restructuring the country's debt would take time, he reminded them, and for the moment Greece had a 15-percent-of-GDP deficit to finance. The only way of financing it, Papandreou argued, was for the country's Eurozone partners to extend a bridge loan and for the European Central Bank to provide Greek banks with Emergency Liquidity Assistance (ELA).

Papandreou, in fact, was not enamoured of having his name added to the long list of Greek premiers forced to oversee a default. Much of the Greek government's debt was held domestically, so restructuring it would not exactly burnish his popularity. Foreign banks also held Greek debt, and the impact of restructuring on their solvency was uncertain. A Greek restructuring would also raise questions about whether other highly-indebted European sovereigns would follow. Default, Papandreou cautioned, could be another Lehman Brothers, only worse.

European leaders displayed admirable calm in the face of these dire warnings. Trichet, rather than opposing debt restructuring, opposed the Emergency Liquidity Assistance, noting that the ECB's mandate limited it to lending against good collateral. German Chancellor Angela Merkel and French President Nicolas Sarkozy, not happy that their banks had recklessly taken positions in Greek bonds, agreed that those banks should now bear the consequences. If banks failed, then the German and French governments would resolve them, bailing in stakeholders while preserving small depositors.

Chancellor Merkel was adamant: asking Greek taxpayers to effectively bail out foreign banks was not only unjust but would aggravate moral hazard. The German public, still enraged by the bad bank behaviour that led to the financial meltdown, backed her hard line. Sarkozy may have been less firmly committed, but he was convinced by Merkel's argument that another bank bailout would ruin his chances of re-election.

Greece seeks the help of the IMF

Seeking a more congenial alternative, Papandreou's next stop was the IMF. Its managing director, Dominique Strauss-Kahn, was happy to do business. The question was what kind of business exactly. The US Executive Director, always an influential voice in the Board, argued against a debt write-down. Channelling the views of the US Treasury, he warned that weak European banks could collapse, triggering contagion to already-weak US banks. Better would be for the IMF to ignore its 2002 Framework on Exceptional Access and extend Greece a large loan, as much as 30 times quota, on systemic-stability grounds.

However, IMF staff's debt-sustainability analysis showed that Greece's debt was already too high for this large loan to be paid back. Stabilising the debt/GDP ratio in its wake would require a massive fiscal contraction that would plunge the country into depression. Fiscal multipliers estimated in house predicted that GDP could fall by 25% in three years. This was no way for Strauss-Kahn to advance his French political ambitions. The managing director quickly concluded that the expedient path was to ally with European leaders and embrace the priority they attached to debt restructuring.

At the landmark meeting of the IMF Executive Board on Sunday 10 May, European directors overrode the objections of the US Executive Director. The Board agreed on a programme assuming a 50% haircut on Greek public debt. This would make it possible for the Fund to lend Greece just enough to finance a budget deficit of 10% of GDP for three years, supporting continued growth or at least limiting the depth of the country's recession. Fiscal consolidation was still required but for the moment would be limited to 5% of GDP, which was just possible for Greece's new national union government to swallow.

In return for this help, Greece was asked to prepare a programme of structural reforms, starting with product market reform and proceeding after that to labour market reform. (Product market reform first because it lowered prices and increased households' spending power, thereby not worsening the recession, labour market reform second because it lowered wages and reduced households' spending power only later when the economy was better able to handle it.) Programme documents gave the Greek authorities considerable leeway in the design of these measures and acknowledged the reality that they would take time to implement.

The Greek government having been reassured of IMF support commenced negotiations with its creditors. A market-based debt exchange, in which investors were offered a menu of bonds with a present value of 50 cents on the euro, was completed by the end of the year.

Spain and Ireland in distress

The French and German authorities nationalised their worst-hit banks and bailed in their large creditors. Spillovers to the US and global financial systems were minimal. Members of the Bundestag congratulated themselves for having defeated moral hazard. The French lionised Mr. Sarkozy, the presidential candidate now wearing the mantle of François Mitterand, the esteemed leader who nationalised banks in 1981.

But, as Papandreou had predicted, what happened in Greece didn't stay in Greece. If restructuring could happen there, then it could happen anywhere, the obvious candidates for 'anywhere' being Ireland and Spain. Both countries had experienced massive housing bubbles, which started deflating in 2007, bequeathing problems for their banks. Now the prices of bank CDS (insurance policies for the banks) plummeted, and risk premia on Irish and Spanish bonds soared as investors bet on the probability of a government bailout of the banks.

On 18 October 2010 Merkel and Sarkozy took their famous walk on the beach in Deauville, after which they issued a joint statement affirming that unsecured creditors would be bailed in. Markets were alarmed, but Merkel and Sarkozy stayed the course; there was no waffling over the merits of bailout versus bail-in. At the stormy European Summit that followed, they insisted that Ireland and Spain administer the same medicine ingested by their own banks. The Irish and Spanish authorities dutifully obliged, bailing in unsecured creditors while protecting small depositors. Where the funds from unsecured creditors were not enough, they broke their insolvent lenders into good and bad banks, allowing the good banks to resume lending while the bad banks were wound down.

But if bank creditors could be administered a haircut in Ireland and Spain, they might also take a haircut elsewhere. Deposits haemorrhaged out of Italian banks, and the prices of bank bonds fell further. European leaders responded in December 2010 with what came to be known as 'Banking Union'. All countries raised deposit insurance coverage to €100,000. A common fund to backstop national deposit insurance schemes was immediately created using dedicated fiscal transfers, with the proviso that these transfers would be returned to sender as levies on the banks flowed in, fully capitalising the fund. To reassure governments that calls on the common fund would be limited, the ECB was given supervisory authority over the member's banking systems.

Still, confidence once damaged does not return overnight. The success of bail-in, banking union, and Greek structural reform were all uncertain. Investors continued to dump the bonds of weak Eurozone economies, straining government finances and causing questions to be asked about the very survival of the euro.

The answer came with Trichet's famous 'do whatever it takes' speech in London in late 2010, the ECB president having concluded that the central bank's lender-of-last-resort responsibilities trumped his desire to be seen as a Teutonic-style inflation fighter.

Recognising that bank resolution, however well organised, took time, the ECB cut interest rates repeatedly in early 2011 to offset the deflationary effects. It then initiated a programme of quantitative easing, purchasing government bonds at a rate of €100 billion a month initially for two years. That spreads had fallen made the nationality of those bonds a non-issue, which in turn made this substantial volume of purchases possible. Lower spreads also made it easier for the Irish and Spanish governments, both lightly indebted, to continue running modest budget deficits, thereby supporting the continued expansion of their economies.

It helped that Germany, with leadership from Merkel, relaxed its efforts to eliminate its own budget deficit. Ever the realist, Merkel concluded that it was impossible to keep turning down other countries' requests for a bailout without offering a helping hand in the form of faster growth in Germany. She accepted the argument, made by the IMF and the Commission that resolving the Crisis required rebalancing within Europe and that rebalancing could not occur solely through deflation in other countries. It required higher wages and prices in Germany.

Following the Nice Summit, the chancellor therefore asked her finance minister, Wolfgang Schaueble, either to resign or to abandon his contractionary fiscal policy. Schaueble, long a proponent of 'ever closer union', reluctantly accepted that fiscal expansion was a necessary price in order to achieve this precious goal. The Merkel government took advantage of the unprecedentedly low level of interest rates to propose a bond-financed programme of infrastructure spending, boosting its popularity at home and stimulating faster growth not just in Germany but in its Eurozone partner economies as well.

Concluding remarks

Thus, by the end of 2012, following three years of turmoil, the Crisis was over. Growth in Europe had resumed. That growth enabled governments to begin narrowing their budget deficits, reassuring the markets of the sustainability of their debts. Aggressive easing enabled the ECB to hit its 2% inflation target. With prices rising by 4% in Germany, rebalancing within the Eurozone proceeded without forcing a disastrous deflation on countries like Greece.

What is remarkable, in hindsight, is the combination of pragmatism and reasoning based on sound economic principles displayed by European leaders. Instead of finger pointing, they acknowledged that they were collectively responsible for the Crisis. Rather than allowing macroeconomic policies to be dictated by ideology and doctrine, they modified their policy stance in response to evidence. Instead of allowing their decisions to be dictated by the bank lobby, they stood by their no-bailout rule. The IMF similarly stood by its principles, pushing for debt restructuring and relief despite warnings of impending disaster by the bankers.

The Dutch and Finns, among others, continued to suggest that the Stability and Growth Pact should be strengthened through the application of even more intrusive and bureaucratic measures. Old ideas die hard. But as fiscal positions strengthened, their counterproductive proposals were shelved. As debts declined to sustainable levels, control over national fiscal policies was restored to national governments. Those who claimed that the euro could not work without political union were proven wrong. The ultimate measure of success is that policymakers in various parts of the world are now actively contemplating own monetary unions of their own, following the European example.

This eBook collects essays from a broad range of leading economists on a simple question: "What more needs to be done to fix the Eurozone?" Although the authors disagree on solutions, there is a broad consensus on the list of needed fixes. These include:

- Completing the Banking Union;
- Breaking the 'doom loop' between banks and their sovereigns;
- Ensuring EZ-wide risk sharing for Europe-wide shocks;
- Cleaning up the legacy debt problem;
- Coordinating EZ-level fiscal policy while tightening national-level discipline;
- Advancing structural reforms for a better functioning monetary union.

Each chapter presents solutions to one or more of these challenges. Taken together, they are the most complete catalogue of solutions to date – representing views that range from calls for sharp increases in European integration to those that favour national, market-based solutions.

The authors, drawn from a wide geographic range and all schools of thoughts, are: Thorsten Beck, Agnès Bénassy-Quéré, Peter Bofinger, Giancarlo Corsetti, Paul De Grauwe, Barry Eichengreen, Lars Feld, Daniel Gros, Refet Gürkaynak, Matthew Higgins, Yuemei Ji, Sebnem Kalemli-Ozcan, Stefano Micossi, Tommaso Monacelli, Elias Papaioannou, Paolo Pesenti, Jean Pisani-Ferry, Chris Pissarides, André Sapir, Isabel Schnabel, Christoph Schmidt, Guido Tabellini, Volker Wieland, and Charles Wyplosz.

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Centre for Economic Policy Research
33 Great Sutton Street, London EC1V 0DX
Tel: +44 (0)20 7183 8801 Fax: +44 (0)20 7183 8820
Email: cepr@cepr.org www.cepr.org