LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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WHAT FUTURE FOR THE EUROZONE?

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1. A currency without a state

The euro is a currency without a state nor economic policy institutions to ensure budgetary discipline and economic convergence amongst its members and protect them from large idiosyncratic shocks.[2]

As it were, convergence was badly wanting amongst the 12 countries that adopted the euro in 1999 (ECB 2015b), not only in prices, wages and productivity, but also the quality of institutions (Boltho and Carlin 2012; cf. Chart 1). In the early years of the euro the single monetary policy generously accommodated divergent national policies (Micossi 2015), thus contributing to the build-up of unsustainable imbalances in peripheral countries.

When the financial crisis struck, the absence of risk sharing arrangements to cushion the shock brought the common currency close to breaking point. The poisonous cocktail of mistrust between the member states and lack of effective common instruments to meet the shock led not only to excessively tight monetary and fiscal policies, but to **a meltdown of confidence** that swell massively the real economic costs of the crisis. In the process, it has become apparent that the construction does not have an exit door – as once again confirmed by the unfolding Greek drama. Thus, the eurozone has evolved into a **highly disfunctional marriage** entailing much suffering and discontent among its participants (Wolf 2014), not easy to fix but neither to abandon.[3]

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[2] The Delors Report (1989), which set out the blueprint of the economic and monetary union (EMU), pointed out that "monetary union is only conceivable if a high degree of economic convergence is achieved" (p. 14). The Report contained no discussion of the political underpinning of monetary union, but the subsequent Treaty of Maastricht (1991) created the European Union as the forbearer of political union to come, together with the key institutions of monetary union.

[3] Nothing new under the sun, notes on these developments Eichengreen (2015): "The single greatest failure to learn appropriate lessons from … earlier history was surely the decision to adopt the euro" (p. 382). The 1920s

2. The causes of the eurozone crisis in 2010-12

In 2010-11 the eurozone was hit by **a classical balance of payment crisis**, with attendant 'sudden stop' of cross-border capital flows to peripheral countries (Wolf 2014, Merler and Pisani-Ferry 2012). Contrary to the narrative developed by creditors in the European Council, the fiscal crisis in many a peripheral countries was the result, rather than the cause, of the financial crisis (De Grauwe and Yuemei 2013, Wolf 2014).

The Greek fiscal crisis acted as a detonator: on one hand, by alerting the authorities and public opinions in Germany and the other 'core' countries to the possibility of large (and hidden) violations of the common fiscal rules;[4] on the other hand, by awakening investors in financial markets to the risk of a sovereign default in a system where the provision of liquidity to ensure the orderly rollover of distressed sovereigns is not guaranteed – given the Treaty prohibitions of monetary financing of public deficits (Article 123 TFEU) and of bailing out insolvent sovereign states (Article 125 TFEU).

Contagion to other peripheral countries was fuelled by the **joint announcement by Merkel and Sarkozy in Deauville**, in October 2010, that private investors would have to bear responsibility for their reckless lending, opening the way to a large write-down of private claims on Greece on the occasion of the second bailout agreement (Summer-Fall 2011). The flight of private capital brought to their knees one after the other the sovereign bond markets and the banking systems of Greece, Ireland, Portugal, Spain and Italy, and eventually Cyprus, setting in motion a disastrous *doom loop* between sovereign and bank crises. Throughout 2011 and the first half of 2012, instability in financial markets was heightened by the visible disagreements on how to proceed between the member states within the European Council as well as between the latter and the ECB.[5]

3. Coping with the sovereign debt crisis

As was mentioned, under German influence **the unfolding sovereign debt crisis** was read by the European Council as the consequence of reckless fiscal behavior by some of its members. Thus, the Greek crisis marked the shift to restrictive fiscal policies for the eurozone periphery at the very time when the private sector was cutting demand to deleverage and remedy impaired balance sheets (Koo 2015, Wolf 2014).

Austerity pushed the eurozone economy into the double-dip recession of 2010-11, and largely explains the dismal economic performance of the eurozone in international comparison in 2010-14 (cf. Chart 1, upper quadrant).[6] After renouncing the exchange rate instrument, debtor countries found that they did not control their fiscal policy either (De Grauwe 2013).

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and 1930s have indeed shown the dangers of tying diverse countries to a single monetary policy under the gold standard, with large capital amounts flowing into higher interest rate countries for some time, and then suddenly coming to an end with dramatic destabilizing consequences; and then, "the economic pain and political turmoil that would follow when the only available response was austerity".

[4] The excessive deficit procedure of Article 126 TFEU with attendant Stability and Growth Pact (henceforth, the SGP).

[5] For a full account of this 'game of chicken' between the European Council and the ECB cf. Bastasin (2015).

[6] As noted by Eichengreen (2015), there was a component of moralism in the attitude of creditor countries that complicated cooperation in countering the crisis and, on occasion, led to imposing unrealistic conditions upon the debtors, that later had to be revised. This, however, seemingly continues to be the price to pay for creditor countries' willingness to provide financial assistance to debtor countries and condone ECB interventions to

Thus, the **strengthening of the economic governance** in the eurozone took precedence over addressing the confidence crisis in financial markets that was threatening the very survival of the common currency. **Fiscal rules came first**, with new legislation reforming the SGP (European Commission 2014b). Under a separate intergovernmental agreement,[7] the members of the eurozone introduced in their national legislation a hard rule mandating budgetary balance over the medium term. The new **Macroeconomic Imbalance Procedure** broadened surveillance over economic policies to include such economic variables as external imbalances, competitiveness, asset prices, and the stock of public and private debt. Finally, **the European Semester** created a uniform cycle of decision-making for budgetary and economic policies of the member states.

However, over time it became all too clear that **fiscal discipline and economic reform would not suffice** to restore stability. There was also a need:

(a) to mobilize substantial financial resources in support of adjustment programmes; and

(b) to convince financial markets that a sovereign default within the eurozone was not in the offing.

Thus, the eurozone eventually endowed itself with a permanent mechanism to provide conditional financing to member states in financial distress, **the European Stability Mechanism (ESM)**, with effective firepower of up to half a trillion euro.[8]

In September 2012 the ECB launched its new **Outright Monetary Transactions (OMT) programme**, under which it would be prepared to intervene for unlimited amounts in secondary sovereign-bond markets of specific eurozone members, *de facto* setting itself as the lender of last resort in eurozone sovereigns.[9] Financial tensions that had plagued the eurozone over the previous two years started to subside.

The OMT had been preceded, in June, by momentous meetings of the European Council and the Eurosummit that, by reaffirming "resolute action to address financial market tensions … and the commitment to preserve the EMU", de facto took off the table the option of **Grexit** – as it turned out, an important pre-requisite for re-establishing calmer conditions in financial markets. They promoted an ambitious programme of institutional build-up of the Union (later fleshed out by Van Rompuy et al. 2012) that notably included the **banking union**. And, finally,

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stabilize financial markets. The paramount example is Greece (Wyplosz 2015), which by the latest bailout agreement will be asked once again to commit to a sizeable increase in its primary budgetary surplus (some 4,5% of GDP by 2018), in a falling economy with a quarter of the population unemployed, while everybody knows that the country will not pay a penny for its official debt service over the foreseeable future.

[7] The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (2012).

[8] The ESM was empowered to provide loans, intervene in primary and secondary sovereign debt markets and set up precautionary credit lines. A special instrument was set up within the ESM (capped at 60 billion) for recapitalizing banks directly, but its utilization was subject to strict pre-conditions making its use rather unlikely (Micossi 2013b).

[9] These interventions, however, would only be initiated after the country concerned had signed up to an economic programme with the EFSF (the temporary predecessor to the ESM) or the ESM, entailing "strict and effective conditionality". This clause may cast a shadow over the credibility of OMT, as it could make it difficult to activate in the presence of a banking crisis requiring swift action (Wyplosz 2015). The possibility of a precautionary programme may offer a way out, but requires the government's willingness to sign up to a memorandum of understanding on adjustment measures with the ESM well before the country has its back against the wall – something only far-sighted politicians may be willing to do.

they approved a **Compact for growth and Jobs**, acknowledging for the first time that positive policy action also was needed to raise employment and growth – even if the follow up was quite meager.

4. Banking union and private risk sharing

To everyone's surprise, the very complex project of banking union was agreed upon and put in place in about eighteen months, between June 2012 and December 2013.[10] Its main purpose is to **sever the doom loop between sovereign and banking crises**, notably by directly recapitalizing failing banks, which in turn required to transfer supervision to the ECB through the new SSM, and by establishing a resolution system that would eradicate bankers' moral hazard by making shareholders and creditors responsible for losses (bail-in). The entry into force of the SSM, in November 2014, was preceded by a 'comprehensive assessment' of banks' capital position, asset quality and business models, so as to ensure that the integrated European banking system would be free of legacy losses. Once the system was up and running, banks could fail without endangering financial stability; more important, an effective mechanism of **private risk-sharing,** via capital markets, would protect national governments from the need to intervene to rescue their banks (Draghi 2014).

Gros (2013) has argued that with full banking union – also including a supranational deposit insurance – a **fiscal backup would become unnecessary**, since emerging bank losses would be taken up by the deposit insurance system at the federal level, as in the US Federal Deposit Insurance system. The argument is valid only for the crisis of individual banks; no matter how big the deposit insurance fund, it will in general not be sufficient to meet the losses resulting from a systemic banking crisis. Therefore, a fiscal backup is an unavoidable component of any monetary union.[11]

5. The growth question

The growth and productivity performance of the eurozone has been rather unimpressive in international comparison well before the euro inception (Gordon 2012). According to the IMF's latest projections, "growth of only about 1.6 percent is expected over the medium term, with potential growth averaging around 1 percent. The output gap would close around 2020 with unemployment still near 9 percent and inflation reaching 1.7 percent, somewhat below the ECB's medium-term price stability objective" (IMF 2015b, p. 10). The question is whether the eurozone set up has contributed to this dismal performance. Unfortunately, the plausible answer is yes for at least three reasons.

The first one is that **the productivity performance** displays a distinct worsening after the inception of the euro. As may be seen in Chart 1 (middle quadrant), the eurozone total factor productivity (TFP) growth always fell behind that of the United States since 1995; however, while in the 1990s this was mainly due to under-performance by the PIIGS, since the early

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[10] It comprises the Single Supervisory Mechanism (SSM), a supranational resolution system for failing banks (the Single Resolution Mechanism, or SRM), and harmonization but not centralization of national deposit insurance (ECB 2015a). A Single Resolution Fund (SRF) fed by banks contributions will back up the SRM with the means to recapitalize banks emerging from liquidation, in case of need; over time (8 years) the SRF will be 'mutualized' (i.e. the funds will be deployable regardless of the national origin of the funds).

[11] Moreover, as was mentioned, for the time being the eurozone banking union does not include a supranational deposit insurance; the resolution fund is not a surrogate since its task does not extend to covering emerging banking losses. Cf. Regulation (EU) 806/2014, Articles 15 and 27.

2000s the core countries have also fallen behind. As to the PIIGS, the start of the euro seems to coincide with a structural break opening the way to a dramatic fall.[12]

The second euro-related reason for dismal growth may be the **deflationary impulses** generated for the eurozone by the pronounced real depreciation of the anchor country vis-à-vis not only the PIIGS but all of its partners (Chart 2, upper quadrant). Following the financial crisis, this effect was compounded by **asymmetric adjustment of external payment imbalances** (Chart 2 middle quadrant): indeed, after the crisis the German current account surplus has grown bigger, rather than smaller, while the external deficit reduction by the peripheral countries was mainly achieved by means of internal deflation.[13] Within-eurozone real exchange rate developments also drove a shift to manufacturing and exporting export sectors in depreciating core economies (Germany above all), and to (less productive) non-tradables in appreciating peripheral countries.

The third euro-related reason for dismal productivity performance is the permanent drag on growth and investment generated by **ballooning sovereign debts** (Chart 2, lower quadrant): this will require indebted countries to maintain primary budgetary surpluses for many years to come and, in addition, will generate positive interest rate spreads, relative to core countries, on sovereign as well as private borrowing. Under the current growth projections, the debt overhang will recede very slowly and therefore capital market fragmentation will persist, implying that highly indebted countries will remain exposed to **idiosyncratic financial shocks**.

The prevailing climate of mistrust between debtor and creditor countries has so far prevented serious consideration of proposals to address the issue through novel **risk sharing** arrangements (e.g. Delpla and von Weizsäcker 2010; German Council of Economic Experts 2011); or with more radical schemes for **debt restructuring** accompanied by changes in governance designed to restore the credibility of the no-bailout clause for sovereigns (Corsetti et al. 2015).

With his Jackson Hole speech, in August 2014, president Draghi broke new ground in eurozone policy-making by openly advocating **expansionary monetary and fiscal policies** to raise growth; soon after, the ECB turned to aggressive monetary expansion also including 'unconventional' policy measures (Micossi 2015). The European Commission has heeded the

[12] In its recent study on potential output, IMF (2015a) finds that the fall in TFP has reflected the dramatic fall in investment (and the related delay in the adoption of the new IT technologies), and also in potential employment due to the impact of aging on labor participation rates. Segmented national market for services, notably in network infrastructures and utility services, at the very time the IT revolution was taking hold, may have also contributed to slowing down productivity. Finally, an important role may have been played by the worsening quality of institution since the start of the euro (Chart 1, lower quadrant): which calls the attention once again to the possible adverse effects on the quality of governance of the lax monetary policies in the early years of the common currency.

[13] It may be recalled that under the Bretton Woods system: (i) the anchor currency country (the United States) entered with a large surplus vis-à-vis the rest of the West, which however was largely offset by large flows of direct investment by US companies in the recovering European and Japanese economies; (ii) in the 1950s and 1960s the dollar exchange rate kept on appreciating in real terms (until eventually the system became unsustainable and broke down); (iii) the US domestic markets were open to the exports of other Western countries (cf. Bordo and Eichengreen 1993). Thanks to the combination of these conditions, the US economy was providing the rest of the world with a continuing expansionary support: exactly the contrary of what the German economy has done to the eurozone. Only recently, after a decade of moderation, wages in Germany have accelerated significantly, rising for the first time above wage increases in the rest of the area.

call: by launching a new plan for stimulating private investment through the EIB (European Commission 2014a) and by relaxing somewhat the SGP (European Commission 2015). The success of these initiatives, however, is predicated on policy changes at national level – including market opening measures in network utility services and supportive fiscal changes in countries with more fiscal space – that are not yet in sight. Unfortunately, unless growth can be lifted substantially, the eurozone will remain a fragile construction with an uncertain future.

6. The way forward

As has been described, the sovereign debt and banking crises of 2010-12 have led to significant changes in the institutions of the eurozone. However, the credibility of common policies regarding budgetary discipline and economic convergence remains weak, due to the paramount role played in the process by intergovernmental decision-making (Fabbrini 2015). Risk sharing arrangements are inadequate to eliminate the risk of renewed massive idiosyncratic financial shocks; should it happen again, the exit of one or more of its members could become unavoidable. And there is no agreement between the member states on the actions required to tackle the causes of lackluster growth – itself a cause of the fragility of the construction – which as a consequence have fallen disproportionately on the shoulders of the ECB.

At the very core of disagreements between the core and the (Southern) periphery stands the question of the appropriate trade-off between 'responsibility' to keep moral hazard under check and 'solidarity' to lighten the burden of adjustment and convergence in highly indebted countries. The Four+One Presidents report (Juncker et al 2015) has proposed to put the house in order first, notably with further transfer of sovereignty to common institutions and formalized arrangements to guaranty economic convergence (following Sapir and Wolff 2015); further institutional advancements would then be possible with complete banking union (including supranational deposit insurance and a surrogate fiscal back up in the form of a credit line from the ESM) and eventually fiscal union (including a eurozone budget).

In principle, stronger credibility of common polices and national policy commitments can be achieved either by complete decentralization of decisions to the national level and rigid enforcement of the no-bail out Treaty clause; or centralization at the EU level of key budgetary and economic policy decisions, with substantial transfers of sovereignty (Pisani-Ferry 2015). The former solution would never be credible owing, among other things, to the sheer size of sovereign debts of some members; and there is little appetite for the latter.

Thus the likely scenario is that of a continuation of current arrangements, perhaps strengthened by further legal arrangements to underpin national policy commitments and, possibly, direct intervention powers by a new executive figure (the European finance minister) in case of deviations from national policy commitments. However, the complexity of the new economic governance does not help national ownership of common policies, at a time of mounting euro-skepticism.[14]

[14] The calls for stronger institutions recently coming from French and German quarters are only superficially pushing in the same direction. In France the main goal seems to be that of setting up a common budget able to implement a common aggregate fiscal policy; in Germany it is rather to create some kind of centralised enforcement powers when countries deviate from their policy commitments (e.g. cf. the latest Report of the German Council of Economic Experts 2015).

There is also an unresolved question of democratic legitimacy, owing to the transfer to the European level of executive powers in budgetary and economic policies, which has weakened the scrutiny of these decisions by national parliaments, without a corresponding increase in the oversight powers of the European Parliament (Micossi 2013a).

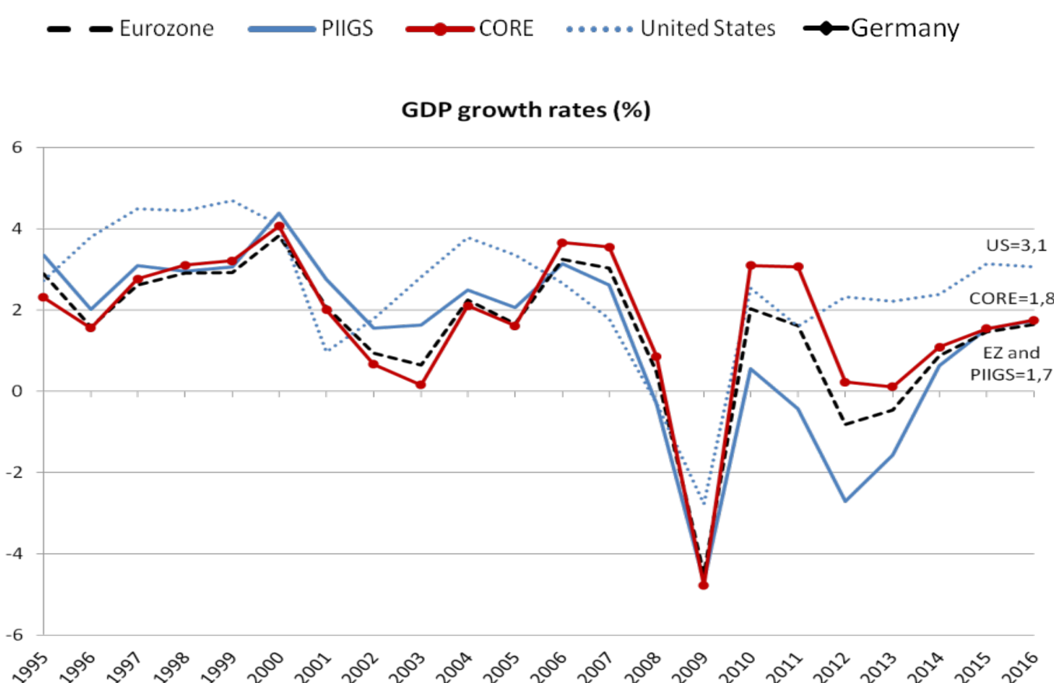
The way forward here is to gradually bring common economic policies under the oversight of the European Parliament (cf. European Parliament 2015), and to strengthen the role of the Commission in the formulation and execution of policies. However, politicization of the Commission, following the 'spitzencandidat' procedure for the selection of the Commission president, is now seen in core countries as an obstacle to a greater role by the Commission.

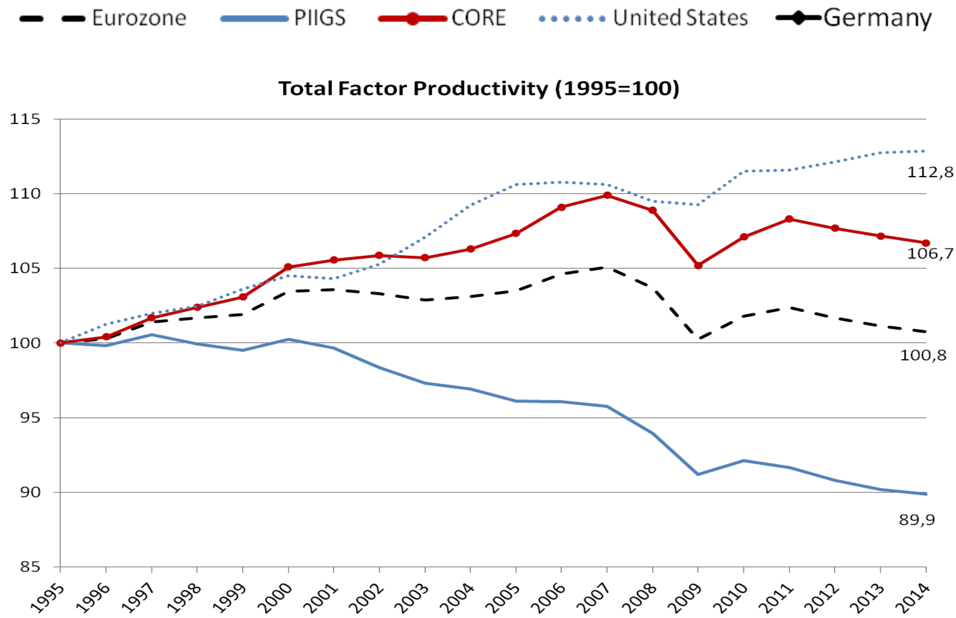
The picture must be completed with appropriate arrangements to get national parliaments more involved in the European policy process, mainly through better exchange of information with the European Parliament and open discussion in national parliaments of country specific recommendations. In sum, here too we are likely to see more evolution and slow adaptation, than revolution.

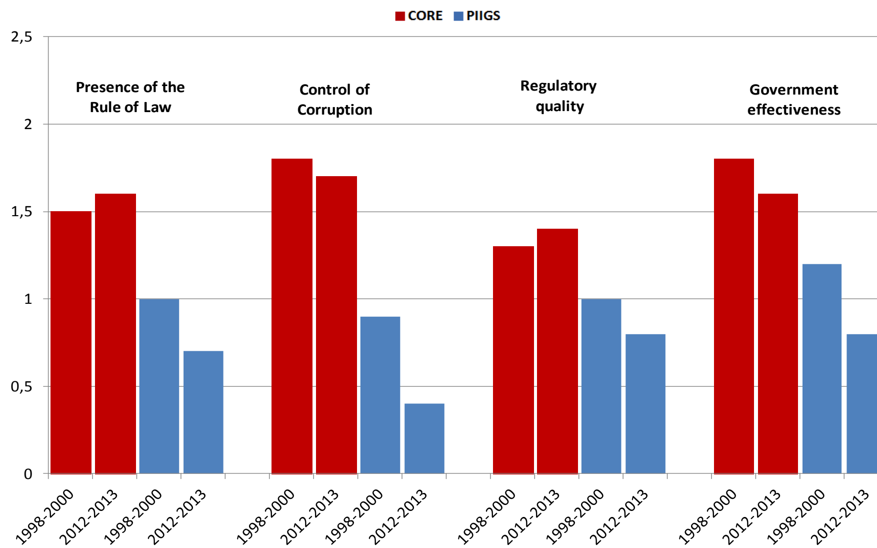
As a final remark, one may recall the results of an in-depth analysis of the evolution of public sentiments (from Eurobarometer surveys) vis-à-vis the European construction by Guiso, Sapienza and Zingales (2015). They find that Europeans are unhappy about the direction taken by the eurozone (and the Union), but still consider it as a useful institution to deal with crises. They still believe in the common currency but show no appetite to move forward with further transfer of powers to the European level. They do not want to go backward either, for dislike of their national political classes as well as fear of the costs of an unraveling of the euro. These findings were fully confirmed by recent events in the Greek crisis.

Thus, the present state of the eurozone could be seen as a sort of political equilibrium, albeit uncomfortable and unstable; the problem of course is that it is likely to prove economically unsustainable.

Chart 1. Growth, TFP and quality of institutions

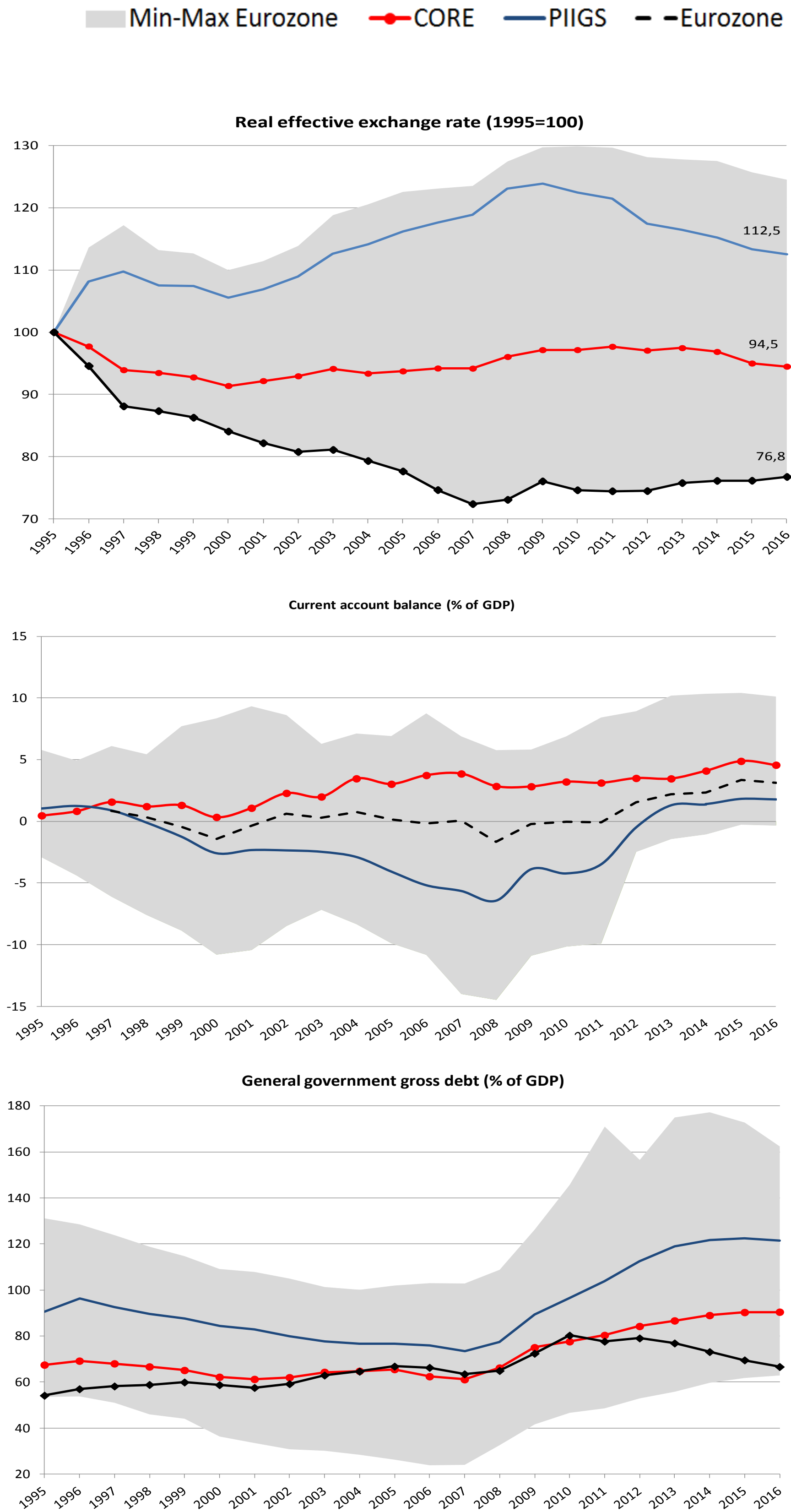






Sources: IMF, Conference Board and World Bank. Notes: Core are Austria, Belgium, Finland, France, Germany and Netherlands. For the lower quadrant, our updating and reclassification of chart from Boltho and Carlin (2012).

Chart 2. Real effective exchange rate*, current account and public debt



Source: IMF and Ameco. *Germany excluded from Core. REER are based on unit labour costs, relative to EU-15.

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