

Advocating new reforms of the E(M)U economic governance

Christophe Blot, Jérôme Creel, Raul Sampognaro, Bruno Ducoudre, Xavier Timbeau, Sébastien Villemot

▶ **To cite this version:**

Christophe Blot, Jérôme Creel, Raul Sampognaro, Bruno Ducoudre, Xavier Timbeau, et al.. Advocating new reforms of the E(M)U economic governance. Saving the euro, Social Europe; Social Europe, pp.133 - 153, 2017, 9780992653750. hal-03458698

HAL Id: hal-03458698

https://sciencespo.hal.science/hal-03458698

Submitted on 30 Nov 2021

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SAVING THE EURO

Redesigning Euro Area economic governance



Edited by
Hansjörg Herr, Jan Priewe, Andrew Watt

Saving the Euro – redesigning Euro Area economic governance

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Jan Priewe, Andrew Watt

Table of Contents

Introduction 1
Hansjörg Herr, Jan Priewe, Andrew Watt

The euro crisis, causes and comprehensive reform guidelines 11

1. A history of the crises of the European Monetary Union 13
Hansjörg Herr

2. How crisis-proof has the Euro Area become? Assessing seven years of reforms 41
Sebastian Dullien

3. An alternative macroeconomic policy approach for the Eurozone 61
Eckhard Hein

4. Fixing the Euro's original sins: The monetary – fiscal architecture and monetary policy conduct 83
Thomas Palley

5. From the Maastricht Treaty to the Euro crisis – exploring guidelines for reform of the Euro system 105
Jan Priewe

6. Advocating new reforms of the E(M)U economic governance 133
Christophe Blot, Jérôme Creel, Bruno Ducoudré, Raul Sampognaro, Xavier Timbeau and Sébastien Villemot

7. There is an alternative: The flexible European currency community 155
Fritz W. Scharpf

Monetary, fiscal and financial sector policy 175

8. How risky is the unconventional monetary policy of the ECB? An assessment of (mainly German) critiques 177
Maik Grabau, Heike Joebges

9. European Monetary Union architecture and governance of finance 195
Helene Schuberth

10. Re-Booting Europe: What kind of Fiscal Union – what kind of Social Union? 223
Willi Semmler, Brigitte Young

11. The golden rule of public investment as a least common denominator to achieve a fiscal stimulus in the Euro Area 251
Achim Truger

Re-balancing macroeconomic imbalances **273**

12. Macroeconomic imbalances in Europe a mistaken concept? **275**
Stefan Collignon

13. Coordinating wages in the European Monetary Union – practical experiences and lessons to be learned **301**
Ronald Janssen

14. European coordination of collective wage bargaining in times of crisis **317**
Torsten Müller

Outlook **333**

15. A feasible conceptual and institutional reform agenda for macroeconomic coordination and convergence in the Euro Area **335**
Willi Koll, Andrew Watt

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Introduction

Hansjörg Herr, Jan Priewe, Andrew Watt

The authors of this book are united in the view that the legal and institutional design of the European Monetary Union (EMU) in its original form is severely flawed. In addition, and related to this, macroeconomic policies in some of the member states before the Great Recession in 2008-9 and even more so from 2010 on were misguided and destabilising. At the same time, most of us do not share the widespread critique that the Euro as a common currency was doomed to fail at birth because a currency union of heterogeneous economies, without flexible labour markets and cross-country labour mobility, can *never* work. We believe that the period following the introduction of the common currency should have been, but was not, used to make EMU workable. Substantial institutional changes can still make EMU successful.

EMU was a semi-complete house before the Great Recession of 2008-9 and remains quite unfinished after the sovereign debt crisis in the Euro Area post-2010, despite a number of reforms. The Euro was and still is an historical

experiment. There is no blueprint, no successful predecessor. Most of the authors in this book share the view that some kind of political union is ultimately necessary, though not in the form of what tends to be derogatorily called a "super-state" – more like a federally structured state like the US. EMU's key shortcomings are rooted in the lack of active macroeconomic policies, especially a prudent and cooperative mix of monetary and fiscal policy and in a lack of at least a certain degree of wage coordination. Some kind of fiscal capacity, be it centralised, decentralised or a mix of both, is necessary, beyond the often pro-cyclical straitjacket of the "Stability and Growth Pact" (SGP).

The so-called *"Five Presidents' Report"* (European Commission 2015) has been helpful in indicating that the heads of the EU institutions agree that Euro Area governance must be developed and deepened if the single currency is to survive. To that extent, there is a shared underlying view with the essays in this book. However, in many regards the report lacks ambition. It represents "business as usual" regarding even stronger enforcement of the prescriptions of the Stability & Growth Pact (SGP) as well as the "Fiscal Compact", aiming at almost balanced structural budgets and targeting the debt ratio at an (arbitrary) 60 per cent of GDP. Behind this focus stands the belief that a – or even *the* – key problem of EMU is fiscal profligacy. National fiscal policy space, the argument goes, is to be further constrained and stricter discipline imposed on member states. In our opinion this will likely evolve into a pro-cyclical fiscal policy with counterproductive results. The Five Presidents also leave no doubt that internal devaluations via lowering unit labour costs in current account

deficit countries, hence flexibilisation of labour markets plus other "structural reforms", cuts in social policy standards and privatisation of state-owned enterprises, are important to stabilise EMU. However, the report was one of the first official documents to at least mention a responsibility among surplus countries to contribute to adjustment as well. There are also proposals going in the direction of deepening governance in novel and potentially helpful ways, including the establishment of a European Treasury, a central "fiscal capacity". However, these issues are addressed in a long-run perspective and in rather airy words.

After Brexit, it became clear that the Euro crisis is only part of a broader crisis, a crisis of the European Union (EU). There are threats of further exits; if not exits, there is broad discontent among large swaths of citizens across almost all member states with the course of European integration, albeit for different reasons. Partly in response to this discontent, the European Commission has outlined five possible scenarios for the EU-27 for the year 2025 (European Commission 2017). The short names for these scenarios are "Carrying on" (1), "Nothing but the single market" (2), "Those who want more do more" (3), "Doing less more efficiently" and "Doing much more together" (5). So far, the Commission has not made its own position clear.

We believe that a functioning monetary union needs more and not less common policy coordination, well beyond the scope of "*intergovernmental coordination*" which all too often ends up in decision-making stalemates owing to the unanimity rule in key policy areas. Not in all but in some key functions of governance, EMU requires joint policy-making. It should be accepted that membership of a currency union

necessitates a strong degree of economic, social and political integration, but not a full-blown new federal state with all its typical features. This should imply more supranational democracy, including greater use of majority rule in more areas, and a shift in power to a parliament deciding politics and policies relevant for the Euro Area, taking it away from the Council and influential informal institutions like the Euro Group. This kind of two-speed Europe has existed since the Euro's inception and should encompass more spheres if further integration is implemented in EMU. In other words, we see deeper integration (Scenario 5) as a *necessity* for the Euro Area countries, implying recognition of the validity also of Scenario 3: some countries doing more without others. There are some key EU policy areas where common and uniform action is needed for the sake of coherence, and others where some countries may do more or less than others. But the delineation between more and less integrated countries cannot be simply a matter of choice: it is determined by membership (or not) of the common currency.

Acknowledging this means that the traditional notion that all EU members sooner or later take part in EMU and follow the path of ever deeper integration towards a "United States of Europe," with nation states withering away, is grossly misleading. It should also be accepted that those EU members which do not want EMU membership or do not fulfil the preconditions may remain in a different but well-accepted status, temporarily or forever.

This book's focus is on the Euro Area and hence largely disregards EMU's embeddedness within the EU, although the salience of this distinction is declining with Brexit. The

15 essays discuss by and large similar reform ideas (with a few exceptions). They are written – some more, some less, accentuated - with a Keynesian mind-set as guiding economic reform principles. All reflect on how the Euro system can be reformed, not on whether and how it should be abandoned. But there are no uniform reform proposals. Earlier versions of the papers presented here were discussed at a symposium in November 2016 in Berlin, organised by the *Macroeconomic Policy Institute* (IMK in Hans Böckler Foundation, Düsseldorf), the *Forum for Macroeconomics and Macroeconomic Policies* (FMM within IMK), the German Social Science Journal *Leviathan* and the Institute *International Political Economy* (IPE) at the Berlin School of Economics and Law.

Our aim is to write for a broader readership, beyond professional economists. Therefore, we refrain mostly from using formulae, models and insider terms only understandable for those in the know. Reference lists are kept short. Even so, some articles are heavier on theory, others more tilted toward policy. Admittedly, our prime question was not the one most policy-makers ask as soon as discussions begin – is it *feasible*, is it enforceable? Most essays ask *what needs to be done*, not what we have on our wish-lists but what is considered a precondition for the functioning and economic success of a currency union. Many proposals require amendments of EU Treaties, but not all. Remaining within the scope of the Treaties provides insufficient leeway. Given the need to change treaties or make new, additional ones, we are aware that deep reforms will take more than a few years. Although not addressed in the essays (apart from one), we believe that a return to national currencies for all

or several members would create huge short-term and long-term problems for both "Remainers" and "Exiteers", bigger than managing reforms. However, one essay – sceptical regarding the governance of a large and heterogeneous EMU – pleads for establishing the preconditions for a feasible and socially tenable break-up of EMU.

Finally, here is a brief overview of what readers will find in this book.

The first seven essays attempt to identify EMU's general design flaws and present comprehensive solutions for the functioning of a common currency system. The first six articles hold that solutions within a currency union like EMU are possible, albeit much more complex than the blueprint of the Maastricht Treaty and the later amendments and supplements suggest. The last essay in this bloc proposes a new mode for exiting the Euro.

Hansjörg Herr traces a short economic history of EMU, especially the period after the financial crises, and analyses the divergent developments with a focus on policy failures that have exacerbated the euro crisis. *Sebastian Dullien* reviews the reforms undertaken to fix the EMU's shortcomings. Even with redressive acts, a number of issues of concern remain unaddressed, leaving the Euro Area akin to a half-finished house. *Eckhard Hein* argues that the EMU architecture suffers from the flaws of the New Consensus Macroeconomics. He proposes a comprehensive reform package based on post-Keynesian macroeconomic theory. *Thomas Palley* holds that EMU is built on a neoliberal concept of monetary and fiscal policy., outlining instead Keynesian reforms. *Jan Priewe* analyses the Euro Area's performance against the backdrop of optimum currency area theories (and their shortcomings)

and derives five reform packages, both from the theories analysed and the critical points of Euro Area performance – with the benefit of hindsight. The team embracing *Christophe Blot, Jérôme Creel, Bruno Ducoudré, Raul Sampognaro, Xavier Timbeau* and *Sébastien Villemot* criticise the macroeconomic performance in the Euro Area after the financial crisis and propose, besides a centralised fiscal policy, national golden rules for fiscal and wage policy as well as "investment plans" in peripheral countries for promoting exports. *Fritz Scharpf* envisages a "Flexible European Currency Community", meaning the option of a break-up of EMU into two interrelated currency areas, based on a new two-tier system: the Euro and a reformed and extended "Exchange Rate Mechanism II" which would allow weaker countries a soft exit and devaluation of their currency.

Seven further contributions deal with specific policies. *Maik Grabau* and *Heike Joebges* look at the zero-interest-rate monetary policy of the European Central Bank (ECB) which has come under severe criticism from German authors and politicians. They find that most critiques are not well-founded and not rooted in a European perspective. *Helene Schuberth* analyses Banking Union, one of the most urgent reforms initiated and already partially implemented, and its limitations. She points to the pro-cyclical shadow banking activity of large banks on the repo market. To avoid the high-risk sovereign/bank nexus she proposes "European Safe Bonds" (ESBies). *Willi Semmler* and *Brigitte Young* discuss the institutional requirements for fiscal capacity building and the introduction of a Eurozone Treasury, supporting a Social Union as an updated European version of the German model of a Social Market Economy. *Achim Truger* elabo-

rates on a pragmatic policy for swiftly re-booting growth by institutionalising the traditional "Golden Rule" for debt-financing of public investment; this could be a lowest common denominator among policy-makers in Europe.

Three essays deal with current account imbalances among Euro Area members. *Stefan Collignon* argues that the EU's "Macroeconomic Imbalance Procedure" leads to austerity measures in deficit countries which do not improve competitiveness. He says that current account balances differ strongly in a currency union from those in countries with their own currency, detects sectoral disequilibria behind the current account balances and considers national imbalances as regional imbalances. *Ronald Janssen* traces divergent wages policies in the Euro Area, but confirms that wage coordination is important to maintain economic and social cohesion within EMU. He warns against internal devaluation now being pursued as entailing deflationary risks. In the same vein, *Torsten Müller* reviews European trade union attempts to implement an alternative model of collective bargaining coordination as the basis for a broader macroeconomic re-orientation towards a more demand- and wage-led growth model in EMU.

In the concluding essay, *Willi Koll* and *Andrew Watt* focus on the need to establish institutions and procedures that ensure balanced growth among all member states, overcoming the centrifugal forces unleashed by differing real interest rates in a monetary union and avoiding damaging imbalances. They sketch out a pragmatic institutional development process to achieve the required mix of monetary, fiscal and incomes policies.

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The euro crisis, causes and comprehensive reform guidelines

A history of the crises of the European Monetary Union

Hansjörg Herr

1. Introduction

Germany, Europe's biggest economy, accounted for 20% of the nominal gross domestic product (GDP) of the European Union (EU) in 2015, followed by the United Kingdom (UK) (17%), France (14%), Italy (11%) and Spain (7%). As for the European Monetary Union (EMU), Germany's share – 29% – is even higher (IMF 2016). However, the German economic position cannot be correctly estimated only by looking at its GDP shares.

Germany has been playing a dominant role due to its export success and its "stability culture" which has also been followed by some smaller northern EMU countries. Before the EMU's creation, the D-Mark dominated the European Monetary System (EMS), which was created in 1979. Member countries of the EMS (and other European countries) pegged

their currencies to the D-Mark. The German Bundesbank dictated the interest rate level of the EMS whereas Germany had the lowest nominal interest rates. Central banks of other EMS countries had to enforce higher interest rates to keep their exchange rates stable vis-à-vis the D-Mark. The system worked because exchange rates were frequently adjusted. In 1992, the UK left the system, while Italy depreciated substantially and temporarily left the exchange rate mechanism. In 1993, further turbulences led to a widening of the band around the agreed fixed exchange rates from +/– 2.25% to +/– 15%. Overall the EMS showed many tensions and fragilities which in the end led to several appreciations in the D-Mark.

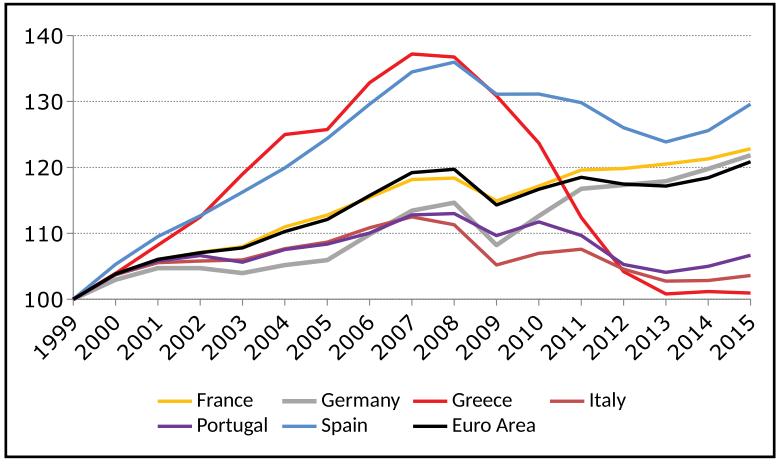
The major problem for EMU is that these tensions and fragilities did not disappear after the creation of the Euro in 1999 – despite the fact that exchange rate adjustments and other national policies were no longer possible. In Section 2 developments in the EMU before and after the Great Recession in 2009 are discussed. Section 3 analyses policies to solve the crisis. Section 4 concludes.

2. The overall development in the Euro Area

Real GDP growth rates differed substantially within the EMU (all data if not otherwise noted come from OECD 2017). Between 1999 and 2008 countries like Spain and Greece realised much higher growth rates than the average; France was close to this average; Italy, Portugal *and* Germany underperformed. All EMU countries were severely hit by the Great Recession. The recovery in 2010 was relatively quick, but the Eurozone slid into a double-dip depression

with shrinking GDP in 2012 and 2013. Since then there has been no significant recovery – a unique situation since World War II. The next cyclical downturn will hit the zone in a very poor condition. After the Great Recession, in terms of GDP Germany became one of the best performing countries. Greece, Italy, Portugal and Spain suffered massively from the crisis (see Figure 1). Ireland showed high GDP growth before 2008, a deep recession and quick recovery. But Ireland is a special case economically dominated by multinational companies and aggressive tax dumping.

Figure 1: Real GDP growth in selected EMU countries, 1999-2015, 1999 = 100



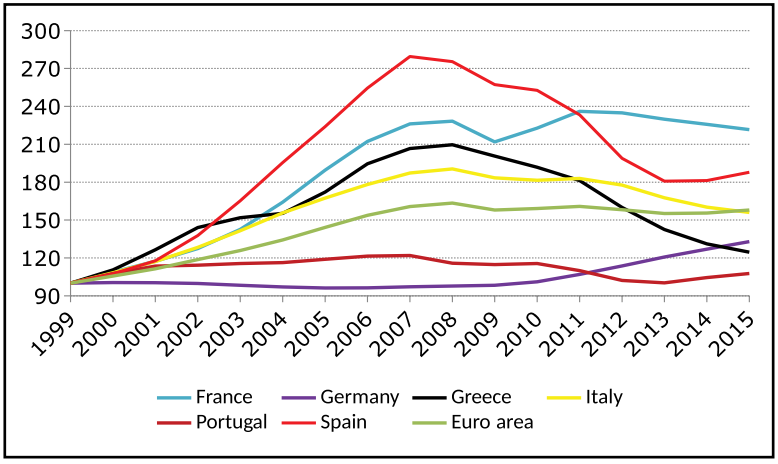
Source: OECD (2017)

The official EMU unemployment rate in 2016 was above 10%, in Greece around 25%, Spain 20%, Italy 13% or Portugal 12%. For these countries, the figures show a lost

decade. In Germany, the unemployment rate was slightly above 4%. However, the volume of hours worked did not increase by much in Germany, only from an index value of 101.7 in 2000 to 103.5 in 2015 (Stat 2016).

One factor to explain the different economic performance within the EMU until 2007 is the development of interest rates. Since the announcement of the European Council in 1992 that the Euro would come into being, short- and long-term interest rates began converging towards the low level obtaining in Germany. For the southern EMU countries low interest rates were a big birthday gift from the Euro.

Figure 2: Real estate prices in selected EMU countries, 1999 – 2015, 1999 = 100



Source: OECD (2017)

The low interest rates together with available credit and lax regulation triggered in most EMU countries real

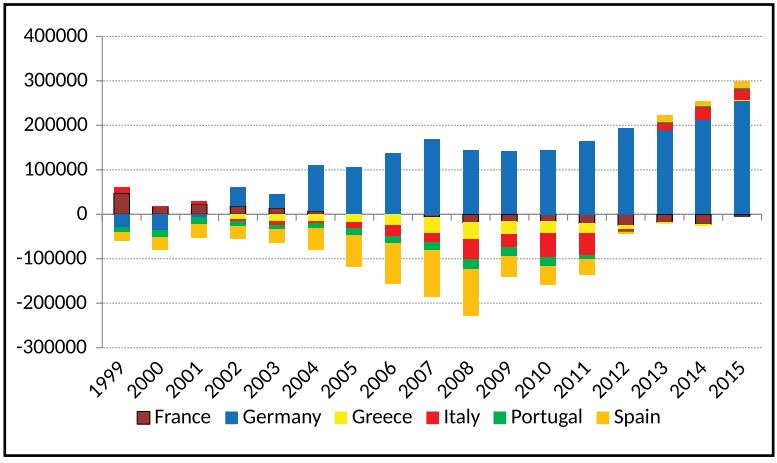
estate bubbles. Between 1999 and 2007 real estate prices in Spain almost tripled, in Greece, France and Italy they more or less doubled. In Portugal, they increased slightly more than 20%. The bubble imploded when the shock of the US-subprime crisis hit the world economy. Spain and Greece in particular suffered from falling real estate prices, but also Italy and Portugal (see Figure 2). In countries with bubbles before the crisis the real estate sector had become an important engine of growth. Not only the construction sector was booming but also consumption was driven by income created in that sector and the positive wealth effect of increasing real estate prices.

Germany did not experience a real estate bubble following the Euro's birth. Only after the Great Recession did real estate prices in Germany start to increase. This has to do with the fact that there was no interest rate shock in Germany and the German financial system is relatively conservative (Detzer et al. 2017). Most importantly, Germany followed policies which did not stimulate domestic demand that could then spill over into a higher demand for real estate. Germany suffered rather from a lack of domestic demand. The red-green government (1998 -2005) under Chancellor Gerhard Schröder implemented a number of labour market reforms given the name of Agenda 2010. In essence, these reforms enabled a sharp expansion of precarious jobs and of a low-wage sector and a decrease in social benefits for the unemployed. Only in early 2015 did Germany introduce statutory minimum wages.

In Germany demand was almost exclusively driven by increasing exports. Coming from a constellation of current account deficits, an exceptional outcome caused by German

unification in 1990, with the start of the EMU the country quickly began generating increasing current account surpluses. It manoeuvred itself into a mercantilist constellation with current account surpluses as a main growth engine (Hein et al. 2016). Current account imbalances in the EMU increased sharply until 2007 (see Figure 3). Greece, Spain, Portugal and Ireland in particular produced high current account deficits measured in per cent of GDP. But Italy slid too with EMU into high current account deficits. There are several factors which explain the imbalances.

Figure 3: Current account imbalances in selected EMU countries, 1999-2015, (million Euro)



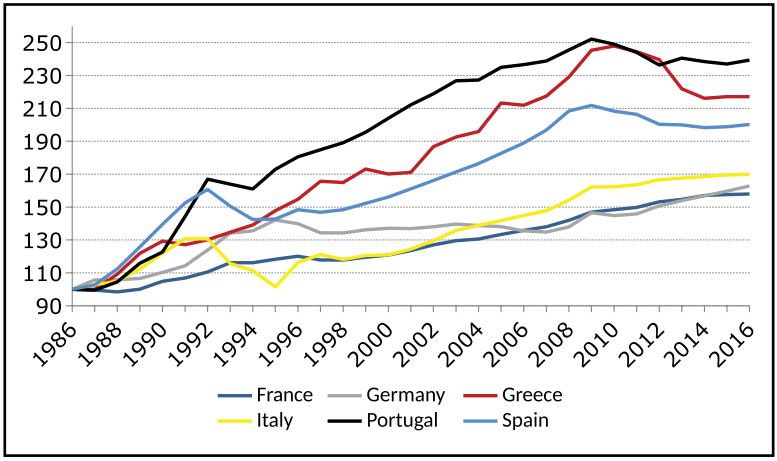
Source: OECD (2017)

First, growth differentials. Germany with its relatively poor growth performance was characterised by relatively low imports whereas high growth in Spain and Greece, for

example, led to high imports and current account deficits. The reduction in the current account deficits of the crisis countries after 2008 has been mainly caused by lower imports as a result of low growth.

Second, price competitiveness explains partly the performance of exports and imports. In a Monetary Union to a large extent this depends on the relative development of nominal unit labour costs. Figure 4 reveals that German unit labour costs stagnated from the mid-1990s until the Great Recession. Indeed, between 1998 and 2007 the increase in German unit labour costs was zero. To realise the target inflation rate of the central bank, unit labour costs should have increased according to trend productivity development plus the target inflation rate – which is in case of the ECB (close to but below) 2%. In contrast to Germany, with its ultra-low wage increases, in southern European countries these were too high, while for example French wage increases were very much in line with the ECB inflation target. Until 2007, for the EMU as a whole, average wage increases followed more or less the inflation target of the ECB which led to an EMU inflation rate of around 2% (Herr and Horn 2012). These developments increased German price competitiveness within the EMU substantially and reduced it for other EMU countries. In 2001, nearly 45% of German exports went to the Euro Area. This means the changes of price competitiveness within EMU fundamentally affected German trade. After the Great Recession, mainly as a result of the crisis in the southern European countries, this percentage dropped to around 36% in 2015. Germany managed to shift part of its exports to the rest of the world, largely thanks to a weak Euro.

Figure 4: Development of nominal unit labour costs in selected EMU countries 1999-2016, 1986=100



Source: AMECO (2017)

Third, non-price competitiveness plays a role. Based on its high-quality products, Germany is seen as a country with low price elasticity in international trade. However, it has been calculated that a 10% reduction in price competitiveness reduces German exports by 6%. For imports, the reaction might be higher (Thorbecke and Waseda 2012).

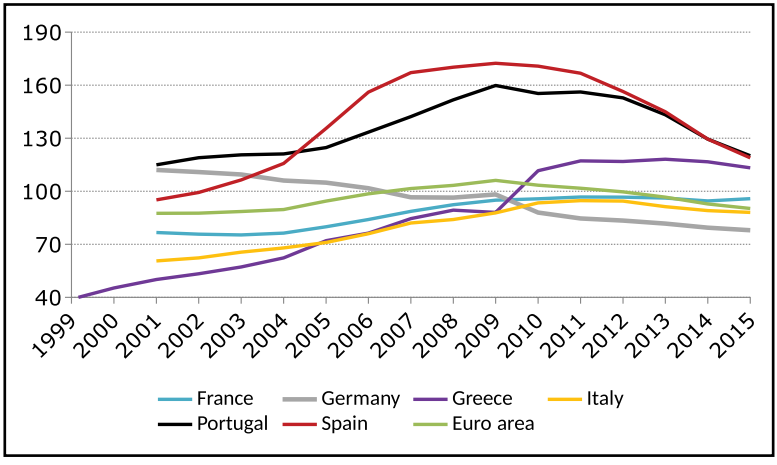
Current account imbalances are only possible with corresponding net capital flows. Not surprisingly, before the Great Recession, current account deficit countries realised high net capital inflows and current account surplus countries high net capital outflows. Between 2003 and 2007 German net capital outflows were 45% of GDP, compared to net capital inflows in Spain of 29.1%, in Portugal 36.6% and Greece 37.5% of GDP. Most of the capital flows were

credit. In 2007 EMU countries had accumulated very high gross stocks of foreign debt in relation to GDP, for example Italy 111.4%, Greece 144.2%, Spain 144.8% and Portugal 202.1%. Germany and the Netherlands, as platforms of international capital flows, had gross foreign liabilities of 135.7% and 290.4% of GDP respectively. The boom phase of cross-border private capital flows (intra-area flows and extra-area flows) in the EMU peaked in 2007 with 40% of area GDP. Then it collapsed to below 5% in 2009 and remained below 10% the following years (Lane 2013). This means that debtors in current account deficit countries were suddenly cut off from credit supply and could not roll over due credits. In emerging markets, where boom-bust cycles became frequent from the 1980s onwards, such a situation leads to twin crises – an exchange rate crisis and a domestic financial crisis. In EMU current account deficit countries cannot utilise devaluation. However, economic units in these countries (financial institutions, firms, governments, private households) were brutally affected by a freeze in capital inflows.

Not only did the cross-border financial flows stop working, crisis countries like Spain and Greece were additionally affected by asset price deflation in the real estate sector that brought about non-performing loans. Financial institutions in the Euro Area which had invested in debt securities and other products that turned toxic with the sub-prime crisis (for example US mortgage-backed debt securities), had their balance sheets adversely affected on top. Finally, the Great Recession and the long stagnation or even shrinking of economies added to non-performing loans. As a result of these developments, financial markets in most EMU coun-

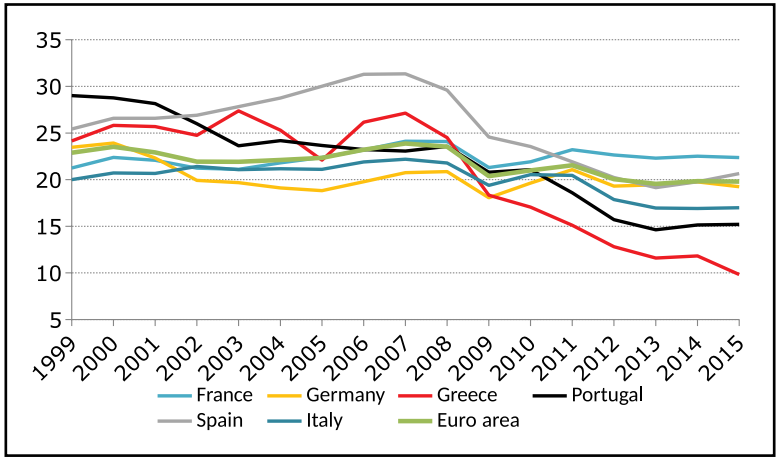
tries did not start working again. Crisis countries suffered from a so-called balance sheet recession (Koo 2011). Figure 5 shows that credit expansion in the EMU to the private sector after a period of high growth stagnated from 2008 onwards. Especially in Spain and Portugal, credit to the private sector as a per cent of GDP decreased substantially. Figure 6 shows that since 2008 gross capita formation in per cent of GDP in most EMU countries has been shrinking or stagnating while, at the same time, Germany's investment performance has not been good. This to a large extent also explains why credit expansion as a share of GDP has been decreasing there.

Figure 5: Credit to the private sector in per cent of GDP in selected EMU countries, 1999 -2015



Source: World Bank (2017)

Figure 6: Gross capital formation in per cent of GDP in selected EMU countries, 1999 -2015



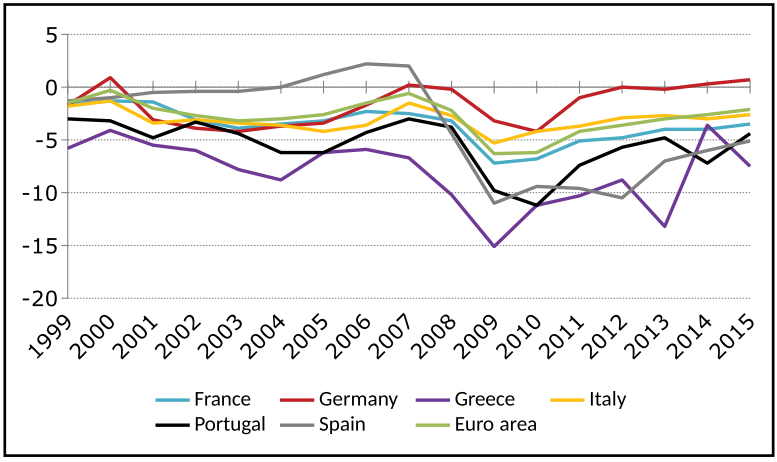
Source: World Bank (2017)

In Germany, in contrast to many other EMU countries, the financial system continued to function normally. Banks ran up losses abroad, but were quickly bailed out by the federal government. There was no debt problem inside Germany. Investment there after 2008 was not good, but it did not suffer from any disastrous development as in other countries. After 2011 German real estate prices started to increase substantially, adding to demand. Together with the high current account surpluses this explains the country's relative good growth performance.

Low growth rates after the end of the internet boom in 2001 led to increasing budget deficits in most EMU countries of between 3% and 4% of GDP. During the economic recovery deficits had dropped below 1% of GDP in 2007. There were

some outliers. Spain, for example, was a model pupil with high budget surpluses. Greece had high budget deficits despite high GDP growth, as did Portugal (Figure 7). Except for Greece and a certain extent Portugal there was no fiscal misbehaviour in EMU's first phase. In 2009 and 2010 budget deficits in the EMU sharply increased to a level over 6% of GDP, in Greece to over 15% and Portugal and Spain to over 10%.

Figure 7: Budget deficits in per cent of GDP in selected EMU countries, 1999-2015

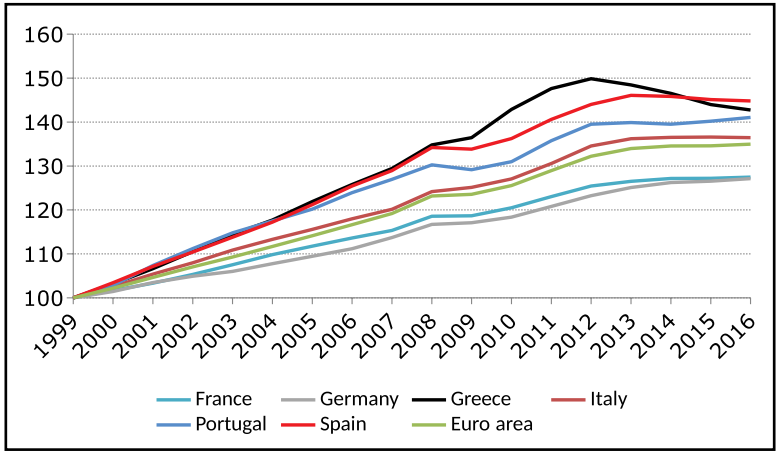


Source: Eurostat (2017)

In contrast to the rest of the world, the "Keynesian phase" in the Eurozone was relatively short. In 2010 policies changed completely and followed strategies in the tradition of the Washington Consensus, including fiscal austerity. Budget deficits in the EMU were slowly reduced but it has been a long and rocky road. Government debt to GDP,

meanwhile, increased in the EMU from around 65% in 2007 to over 90% in 2016.

Figure 8: Consumer price index, 1999 – 2016, 1999=100



Source: OECD (2017)

Let us come to the last important indicator, the inflation rate. Unit labour costs are the most important factor determining the price level (Herr 2009). This is the explanation why Germany for most of the years achieved the lowest inflation rate in the EMU whereas Spain or Greece with relatively high increases of unit labour costs saw relatively high CPI inflation rates. Until 2008 the EMU inflation rate was around 2%, then in 2009 it dropped sharply, but recovered quickly again to 2%. After 2012 inflation rates became very low and stagnated below 1%. Some member countries – Spain and especially Greece – have seen falling price levels (see CPI development in Figure 8). The EMU

as a whole stood on the edge of deflation. In 2017 CPI inflation increased, but core inflation rate remains below 1%.

3. Policies adopted to solve the crisis in the EMU

Financial systems in some of the EMU countries were affected by high-risk and speculative activities in the global financial system and their consequences, including the collapse of Lehman Brothers in September 2008. Europe suffered from the negative financial effects and by a shrinking global economy. But there were homemade problems, too. Real estate bubbles came to their end and burdened financial systems. High budget deficits were caused by decreasing tax revenues, higher public spending related to the crisis, bailout costs of financial institutions and programs to stimulate demand.

Expansionary fiscal policy in the EMU was challenged by the sovereign debt crisis. In early 2010, refinancing costs for public households increased, especially in Greece, Portugal and Ireland. To a lesser extent interest rates for government bonds also increased in Italy and Spain. In Greece it became clear that past budget deficits were higher than officially reported. Confidence in the ability of the Greek and other EMU governments to remain liquid and solvent eroded. No clear statement that EMU governments or the ECB would bailout governments in trouble emerged. The opposite was the case; there was officially a no-bailout-clause as part of EMU fiscal rules. Help for Greece was delayed and only in May 2010, shortly before the collapse of the Greek public budget, was the European Financial Stability Facility

(EFSF) created with a volume of €690 billion by the EMU countries as a temporary crisis resolution mechanism. Greece was bailed out with a €110bn package. Negotiations with crisis governments were carried out by the so-called Troika which represented the International Monetary Fund (IMF), the ECB and the European Commission. However, final decisions were taken by EU finance ministers or government leaders. In November 2010, Ireland was bailed out to the tune of €85bn, followed by Portugal with €78bn in May 2011. Meanwhile, in early 2011, in addition to the EFSF, the European Stability Mechanism (EMS) was planned as a permanent bail-out fund – worth about €500bn – and established in 2012 (later its firepower was increased to €800bn). In July 2011, a second bail-out package of €109 billion was required for Greece. Interest rates on Spanish and Italian government bonds increased sharply. Both countries passed far-reaching austerity measures. In February 2012, the second Greek bail-out package was increased to €130bn. In June 2012 Spain was helped with €100bn. In February 2013 Cyprus received €10bn. It is clear even now that Greece in particular will require further help. The leading role in deciding under which conditions governments should be bailed out was taken over by Germany. All these measures were unable to prevent the sovereign debt crisis and convince financial markets that governments will not fail.

In the following section we discuss how, beyond these afore-mentioned bailout measures, the crisis in the EMU was handled (see also Dodig and Herr 2015). Three policies are in the focal centre: the policy of the ECB as lender of last resort, the policy of internal devaluation and fiscal austerity.

a) The ECB as lender of last resort

A financial system can hardly exist without a lender of last resort. This was already made clear by Walter Bagehot (1873). A lender of last resort is required in the normal daily activities on the financial system, but also during any financial crisis. Of course, a central bank can decide to let some unsound bank or even segments of the financial system go to the wall, but in the end it has to stabilise the relevant financial system to prevent fundamental distortions of the economy. Central banks also take over the function of lender of last resort for public budget entities, at least for the federal government which then helps local budget entities. Central banks must do this as otherwise vital government functions erode. Think of governments not paying policeman, closing hospitals or stopping pension payments. A central bank can help governments if it directly finances the budget, or, if there are legal restrictions, buys government bonds in the secondary market and refinances banks which provide funding for governments.

Looking at the ECB handling of the EMU crisis, judgements are mixed (see Bibow 2016). The ECB, following the tradition of the Bundesbank, oriented monetary policy towards achieving its inflation target. Compared with the US Federal Reserve (Fed), interest rates in 2008 were cut relatively late. However, via several reductions in May 2009, the main refinancing rate reached 1%. A mistake was the increase in the main refinancing rate in 2011 in several steps. However, in July 2012, rates were cut in stages again and gradually reached in 2014 0.05% and in March 2016 0%. ECB interest rate policy can be criticised in detail but has been overall functional.

The ECB also took over a comprehensive function as lender of last resort for the financial system. From October 2008 banks in the EMU could refinance themselves at the main refinancing rate without any limit. The quality of needed collateral for refinancing was reduced in such a way that banks had sufficient room to get central bank money. Special liquidity programs, for example the purchase of (private) covered bonds or long-term credit to banks, were added.

When in 2008 cross-border credit markets in the EMU froze, financial institutions in crisis countries were affected by huge outflows of funds. First, households and firms bought foreign goods and services, paid interest to foreigners etc. and thereby simply transferred deposits of banks in crisis countries to foreign banks. Second, wealthy people in crisis countries were afraid of systemic financial crises in their countries and transferred their financial assets to countries considered to be stable, for example Germany. Such capital flights could be carried out without any exchange rate risk and at low costs. The problem for banks in crisis countries was that they had to balance every evening their cash flows via the TARGET2 (Trans-European Automated Real-time Gross Settlement Express Transfer System). In the boom phase banks could get the funds they required via the money market. But after the outbreak of the crisis this was no longer possible. Banks in need of funds had to finance themselves via the national central bank. Money created by central banks in crisis countries was booked in the ECB as assets of the central banks in the countries receiving the cash flows. Net TARGET2 balances of Germany reached in 2012 €600bn, and of a combined Finland, Luxemburg and

the Netherlands over €1 trillion. This huge sum is around the same as the total balance sheet of the ECB at end-2007. The other EMU countries had corresponding negative net balances. In the following years, these balances reduced slightly, but then increased in 2016 to the old levels (ECB 2017). Via TARGET2, financial systems in surplus countries were flooded with central bank money which they did not use for credit expansion but which were kept as excess reserves with the ECB.

In June 2014, the ECB started its unconventional monetary policy. The interest rate for bank deposits at the ECB (deposit facility) became negative and, in a series of steps, reached -0.4% in March 2016. A year earlier, quantitative easing (QE), already used by other central banks since 2009, was introduced. On average the ECB bought public and private sector securities amounting to €80bn monthly. From April 2017 the amount was reduced to €60bn a month. This unconventional monetary policy was mainly motivated by the poor economic development in the Euro Area and an inflation rate far below the 2% target. In fact, the Euro Area was in danger of slipping into a deflationary development comparable to that of Japan or even worse. QE could have been an opportunity to cleanse the balance sheets of banks of non-performing loans or to help governments in crisis countries. Such a policy, followed for example by the Fed, was not implemented, however.

Let us come to the central bank as lender of last resort for public budgetary authorities. The Fed took over this function without hesitation and without causing any sensation or drama, as did the Bank of England, the Bank of Japan and other central banks. In these countries, no sovereign debt

crisis developed despite the fact that some of the countries had much higher public debt than, for example, Greece. It was a major mistake that the ECB only took over this function incompletely and very belatedly (De Grauwe 2013). This does not mean that countries like Greece could not have been pressured into undertaking the necessary reforms. But to use the bankruptcy of states and send a Troika to enforce far-reaching neoliberal reforms against the will of governments and parliaments in crisis countries is not an acceptable crisis-solving mechanism.

In periods of severe financial market turbulence and in the framework of the Security Markets Program (SMP), the ECB bought in May and July 2010 government bonds mainly from crisis countries with a value of around €60bn and between early August and January 2012 of around €140bn. This was not enough to calm financial markets. Finally, on July 26 that year, Mario Draghi, ECB President, announced in a speech in London: "Within our mandate, the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough." (Euronews 2012) The ECB promised to bail out governments if they got help from EFSF/ESM and followed the requirements of the Troika. In September 2012, the SMP program was substituted by the so called Outright Monetary Transactions (OMT) Program which permitted the buying of bonds from EMU crisis countries without limit if they are controlled by EFSF/ESM. The ECB's commitment proved credible and has not been put to the test by financial markets so far. These actions ended the sovereign debt crisis. German representatives at the ECB strictly opposed policies of allowing the bank to become at least a partial lender of last resort

to EMU. Bundesbank President Axel Weber resigned in February 2011 and ECB chief economist Jürgen Stark in September 2011.

b) Internal devaluation to restore competitiveness

The Troika was right to care for the competitiveness of current account deficit countries in the EMU. But it did not in the slightest way push for a symmetric adjustment mechanism to restore competitiveness. It would have been more functional to push current account surplus countries like Germany towards substantially higher wage increases and fiscal expansion and deficit countries like Greece, Spain or Portugal towards lower wage increases. Instead, deficit countries were pushed into enforcing nominal wage cuts to increase their price competitiveness. Wage cuts were combined with the complete set of Washington Consensus policies, including flexible labour markets, privatisation and deregulation of public utilities. These policies were imposed by the Troika to change societies in a neoliberal fashion (see Scharpf in this volume) – even though in so many cases they had failed in developing countries.

With falling wage costs, consumer price levels in countries such as Greece, Portugal or Spain decreased especially after 2012 – producer price indices fell even down to minus 5%. To a lesser extent, similar developments happened in Italy and France. But in Germany too, inflation rates were very low with the result that the price competitiveness of crisis countries only increased slightly. And there were no focused policies to help these to increase productivity via industrial

policy or other measures. It must therefore be expected that as soon as growth recovers in these countries high current account deficits will return.

Policies to cut the level of wages are never fair. When Britain in 1925 went back to the Gold Standard with an overvalued exchange rate, seeing the way to make itself competitive as cutting wages, Keynes (1925: 3f.) wrote: "Those who are attacked first are faced with a depression of their standard of life, because the cost of living will not fall until all the others have been successfully attacked too (…). Nor can the classes which are first subjected to a reduction of money wages be guaranteed that this will be compensated later by a corresponding fall in the cost of living (…). Therefore, they are bound to resist so long as they can; and it must be war, until those who are economically weakest are beaten to the ground." Wage cuts failed and in 1931 the Gold Standard collapsed when Britain left it.

The Troika's key strategy was to abolish sectoral bargaining, weaken trade unions in general, freeze or cut minimum wages, reduce social transfers and pensions, erode job protection, allow precarious employment and so on (Hermann 2014). Indeed, its policies of bringing down nominal wages in the crisis countries were a kind of "war" and led to extremely unfair and unjust results.

The policy of internal devaluation implies – in addition to social injustice and the loss of social cohesion – deep economic contradictions. It is one of the great puzzles of European crisis management that it was not understood that deflationary policies permanently reproduce non-performing loans. Irving Fisher (1933) and many subsequent economists made clear that deflation increases the real debt burden and

destroys the financial system. It should not be a surprise that financial systems in crisis countries did not start working again and widespread over-indebtedness of economic units characterize their economies. And the ECB inside the Troika must have been acting as a kind of schizophrenic: Pushing for wage cuts and deflation in one half of the EMU and at the same time fighting deflation with QE programs seems an incoherent policy.

c) Fiscal austerity

In 2010, fiscal policy in the EMU changed from an expansionary orientation towards strict austerity. Germany above all pushed for hard fiscal discipline and cuts in government spending. The Troika imposed fiscal austerity on countries dependent on its aid. Other countries, which were afraid to be punished by financial markets, also followed restrictive policies. After 2010, in Greece, Spain and Portugal public spending in absolute terms decreased – in Greece, the most extreme case, around 25% by 2014. In Italy public expenditures almost stagnated, whereas in Germany and France they continued to grow moderately but showed no sign of substantial expanding. The outcome of this far too premature switch to restrictive fiscal policy was a second EMU recession in 2012 and 2013.

When countries suffer from shrinking investment and consumption demand and, at the same time, have current account deficits and cannot easily increase exports, with shrinking government demand on top, a crisis must deepen. The hope of the Troika that neoliberal struc-

tural reform might trigger growth in a stagnating or even shrinking economy is built on sand. Even necessary structural reforms will not lead to spontaneous growth but can have only potential medium- and long-term positive effects. If there are no demand drivers, stagnation can last theoretically forever *even* if required structural reforms are implemented. If investors' expectations are depressed, animal spirts disturbed and finance not available, there will be no tendency for an economy to grow. The neoclassical hope of a bail-in of fiscal austerity in such a constellation seems to be not only illusionary but also cynical. And, of course, the question is which reforms are needed. The Troika interfered in an extremely harsh way in the democratic institutions of countries and enforced reforms which were not accepted by the majority of the population and are certainly not linked positively to growth.

In essence, the crisis countries, including those such as Italy not under Troika control, were forced to follow a policy comparable to that of US President Herbert Hoover from 1929 to 1933. Stiglitz (2016: 18f.) writes about the EMU: "Herbert Hoover fails again (….); his policies of austerity converted the crash into the Great Depression. Since Hoover, such policies have been tried repeatedly, and have repeatedly failed. (…). Why the Troika would have thought that this time in Europe it would be different is mystifying." One could add: Heinrich Brüning, head of the German government from 1930 until 1932 – just before Adolf Hitler came to power – failed with his austerity policies as well.

4. Conclusion

An astonishing point is that institutions like the European Commission or the ECB did not discuss the evolving fragilities shown up in the first phase of the EMU. One can follow Queen Elizabeth II when she asked at a briefing by academics at the London School of Economics on the turmoil on the international financial markets: "If these things were so large how come everyone missed it?" (Telegraph 2008). She could have also asked: Why did nobody see the EMU crisis coming? All this does not speak up for the quality of the macroeconomic management of the EMU. From 2005 at the latest the development of real estate prices in some of the countries, incoherent wage developments, high current account imbalances as well as the state of the global financial system, all should have been at the centre of economic policy debates in the EMU. By the way, Professor Luis Garicano, one of the LSE directors, answered the Queen: "At every stage, someone was relying on somebody else and everyone thought they were doing the right thing." (Telegraph 2008).

EMU crisis management was from 2010 onwards largely misguided. The EMU was unable to organise a lender of last resort for governments and thus let the sovereign debt crisis unfold needlessly. Separating fiscal and monetary policy in the way the EMU authorities did was a disaster that could have been avoided. However, the ECB must be considered as the institution that kept the EMU together, stabilising it during periods of extreme stress.

Internal devaluation, fiscal austerity and neoliberal structural reforms were at the centre of the Troika's strategy.

Internal devaluation via wage cuts implies deflation. Deflation in countries with high domestic debt, as in the EMU crisis countries, leads to high non-performing loans and to the permanent erosion of a healthy financial system. Restrictive fiscal policy in the context of shrinking demand intensifies a crisis. And in the case of structural reforms one has to decide which reforms are needed. And even necessary reforms do not lead to quick economic results. Policies post-2010 pushed the EMU very close to a Japanese-style deflationary stagnation scenario which might continue for decades (Dodig and Herr 2015a). However, the political context and dynamics of a stagnating EMU is different to Japan's situation and could even destroy the European project.

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How crisis-proof has the euro area become? Assessing seven years of reforms

Sebastian Dullien

Introduction

In the seven years since the outbreak of the Greek debt crisis in 2010 (which then quickly turned into a crisis of the whole currency area), the Eurozone has seen a flurry of reforms. Not only were fiscal rules tightened repeatedly and new rules and potential sanctions for persistent macroeconomic imbalances introduced, but also the architecture of financial and banking oversight completely overhauled. In addition, lending facilities with volumes of several hundred billions were created which can now be tapped by countries with liquidity problems. Finally, the European Central Bank (ECB) introduced the "Outright Monetary Transaction" framework under which it can buy bonds of embattled countries to help these countries retain access to financial markets.

And, yet, the reform process is not at an end. Several further reform proposals are still in the legislative process while others remain under discussion. The "Five Presidents' Report" (drafted by the presidents of the European Council, the European Commission the Euro-Group, the European Central Bank and the European Parliament) foresees a permanent reform process, spanning until 2025, before the euro-area will be "completed" (Juncker et al. 2015).

This contribution gives an overview of the reforms already implemented and currently still being negotiated and analyses how far these changes are sufficient to prevent a replay of the crisis which has haunted the euro area since 2010. In order to conduct this analysis in a structured way, it will first take a look at the underlying causes of the euro crisis. In a second step, it will describe the reforms implemented in detail and analyse how far these address the different factors which have contributed to the crisis.

Origins of the Crisis

Even though there has sometimes been the perception among the general public that the euro crisis has been a simple sovereign debt crisis, its origins have in fact been much more complex and multi-dimensional. While Greece, the first crisis country, indeed had problems with excessive government debt and large government deficits, the story for Ireland and Spain has been very different: In both, public finances were in excellent shape before the outbreak of the global financial and economic crisis of 2008/9. Both countries were running fiscal surpluses prior to 2008, and both

had public-debt-to-GDP ratios far below the Maastricht threshold of 60 percent. The end of a real estate boom and the meltdown of their national banking system plunged them into the crisis. Italy, in contrast, seems to have been mostly a victim of legacy debt and a stagnating economy.

Consequently, the emerging consensus among economists is that the euro crisis had a number of interacting origins. Broadly, one can identify seven crisis elements (Dullien 2014):

1. **Shaky public finances:** While the crisis has not everywhere been primarily a public debt crisis, at least in some cases, unsustainable public finances were an important element in the genesis of the crisis. In Greece, fiscal deficits had been persistently above 3 percent of GDP and debt-to-GDP ratios above a 100 percent of GDP. In Italy, debt-to-GDP ratios have also been high, primarily as a consequence of high deficits in the period before the introduction of the euro (even if deficits since then have been rather moderate).
2. **Boom-and-bust cycles in the periphery:** With falling borrowing costs after the introduction of the euro, many countries in the euro periphery experienced an economic boom. As inflation in Spain, Ireland or Portugal was higher than in the euro area core, but the nominal interest rate was roughly the same, real interest rates in these countries were much lower than in Germany or the Netherlands. This boosted investments, especially in housing, which in turn boosted economic growth, employment, wages and inflation. The boom ended when real estate price increases came to an end and the periphery countries found themselves in a situation of a vastly diminished price competitiveness.

3. **Problems in the banking sector:** As a result of these boom-and-bust cycles, but also because of the engagement of some of them in the securitized U.S. subprime mortgage sector, banks in several euro countries had to write down assets and saw their capital buffer dramatically shrink, prompting governments to bail out banks. The banking sector became a drag on economic growth (because banks became more careful in their lending decisions) and a burden for public finances.
4. **Toxic link between banks and sovereign debt:** In most euro area countries, banks hold a significant share of their assets in domestic bonds. This created a vicious circle of escalating bank balance sheet problems and sovereign debt problems. When investors became wary of problems in a country's banking sector, they began anticipating that large bail-outs would become necessary. As a result, they started doubting the sustainability of public debt and sold government bonds, pushing down prices and forcing the banks to write down their holdings, exacerbating those balance sheet problems.
5. **Self-fulfilling market panics:** Doubts about governments' ability to service their debt have exacerbated the sovereign debt problems. Falling confidence in some governments led to a sale of their bonds, pushing down prices and increasing yields. These rising yields made it difficult for the countries in question to access markets and service their debt. As discussed in the literature on self-fulfilling crises (Cole/Kehoe 1996), some euro area countries were thus pushed to the brink of insolvency simply by deteriorating investor confidence.
6. **Structural divergence of price competitiveness:** In the first decade after the euro was introduced, euro area

countries experienced a dramatic divergence in price competitiveness, *inter alia* caused by structural differences in wage setting institutions. In countries such as Germany, Austria or the Netherlands, unit labour costs grew much more slowly than in the euro area as a whole, while countries such as Ireland, Greece and Spain experienced much higher unit labour cost increases. When the euro crisis hit, the latter group of countries found themselves in a position of very weak price competitiveness. They experienced subsequently an extended period of poor economic growth.

7. **Loss of the population's trust in existing (European) institutions:** The long period of high and rising unemployment, of low economic growth and falling or stagnating disposable household incomes has led to a crumbling of the population's trust in existing national and European institutions. As a result, support for populist parties has grown in many euro area countries. This support has started to interact with the economic dimension of the crisis: As populists question their country's euro membership or at least their country's adherence to European fiscal rules, investors start selling government bonds as soon as a country experiences a populist surge, pushing up yields and hence creating new problems of debt sustainability for the countries concerned.

Reforms implemented since 2010

As a reaction to the crisis, policy makers have introduced a number of changes to the euro-area's governance framework. The main reform areas implemented since 2010 have been the following:

1. **Reform of fiscal rules:** European policy makers significantly tightened fiscal rules in the two legislative packages dubbed "six pack" and "two pack". Most importantly, the new rules force euro member states to abide by a synchronised budget cycle under which draft budgets have to be submitted already in the prior autumn for vetting by the European Commission. In addition, medium term budget targets are defined as well as the speed with which euro area countries have to correct excessive budget deficits. Moreover, countries with debt-to-GDP ratios above 60 percent are now obliged to bring down the debt level by one twentieth of the difference between their actual debt level and the 60-percent threshold each year. Excessive deficit procedures can now be initiated even when the deficit itself is below the 3-percent-threshold, but if the debt-to-GDP ratio is not reduced with sufficient speed. The voting rules in an excessive deficit procedure have also been fundamentally changed: In order for such a procedure to progress, a qualified majority is no longer necessary. Instead, countries need a qualified majority to stop the process. With the fiscal compact, an additional multilateral treaty separate from the EU treaties, euro area members agreed to codify some of the EU's basic rules on deficit and debt reduction in national law, preferably within their constitutions. If member states fail to fulfil these commitments, they can be sued by other member states and fines can be imposed.
2. **Introduction of mechanisms to deal with excessive macroeconomic imbalances:** A formal procedure has been implemented to deal with macroeconomic imbal-

ances. In many aspects, this works similarly to the one that deals with excessive deficits. Potential imbalances are monitored, countries may be warned, and if a country persistently fails to correct macroeconomic imbalances, fines can even be imposed. Yet, the mechanisms to evaluate macroeconomic imbalances are much more complicated than those for an excessive deficit: Instead of focusing on single indicators, macroeconomic imbalances are evaluated using a scoreboard with more than a dozen indicators (including current account imbalances, growth in private indebtedness and growth in unit labour costs) and a discretionary process to make the final judgement.

3. **Creation of large lending facilities for governments in financial trouble:** The no-bail-out clause found in the Maastricht Treaty, which prohibited other countries and the EU from assuming liabilities for individual member states, has been softened. With the escalating crisis, European policy makers first created the temporary European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF), which was then replaced by the permanent European Stability Mechanism (ESM). With pay-ins and guarantees from the euro area member states, the ESM is able to lend up to €500 billion to euro member states which have lost or are about to lose access to financial markets. As ESM programs usually come with conditionality, its lending facilities now work similar to those of the International Monetary Fund (IMF).
4. **Reform of the ECB's monetary policy framework:** Independently of the heads of state and government and the European Commission, but nevertheless very

important for the broader question of crisis-resilient euro area architecture, the European Central Bank has changed its operating framework and moved closer to becoming a true lender-of-last-resort for euro area governments. Under the term "outright monetary transactions (OMT)", it has announced that it would be willing to buy government bonds in the secondary market with maturities of up to three years from countries which are threatened with no access to financial markets, provided these countries have agreed on a conditional loan package with the ESM. As the ECB is not constrained in its money creation, this new tool effectively allows the central bank to indirectly lend as much liquidity as might be needed to a government under pressure, thus greatly increasing the financing volume effectively available for countries under ESM programmes.

5. **Reform of the financial oversight structure:** Within the framework of the newly created banking union, financial regulation and oversight has been moved to the ECB. It is now responsible directly for the oversight of larger banks in the euro area and indirectly (through national authorities) for the oversight of all banks in the currency union. In addition, capital requirements for banks operating in the EU have been greatly increased. Even prior to the inception of the banking union in 2012, the EU had started to centralize financial market oversight as a reaction to the 2008/9 crisis with the creation of oversight authorities for banks, markets and insurance.
6. **Introduction of a common framework for bank resolution:** Also within the banking union, a common framework for dealing with banks in trouble has been

created. Under these rules, the decision on how to resolve or rescue a bank is taken at a central level and supposedly under uniform rules. Banks are required not only to hold a certain amount of equity capital, but also of subordinated debt instruments which can be bailed in. Such a bail-in of private creditors is a requirement for the injection of public funds into an ailing bank. In order to shelter national governments from the fall-out of domestic banking crises, a Single Resolution Fund (SRF) has been created which is supposed to finance bail-outs, with the costs being mutualized over the coming years.

Further reforms in the legislative process

In addition to the reforms already implemented, there are some proposals stuck in the legislative process. Among the issues still under active discussion are first and foremost a completion of the banking union and the creation of a capital market union. On the banking union side, one pillar, the European Deposit Insurance Scheme (EDIS), has not been implemented yet. Under such a scheme, all banks would pay a fee into such a common scheme. If a bank failed, retail depositors would be compensated up to the amount of €100,000 from this insurance scheme. EDIS is supposed to replace the existing national schemes which guarantee the same coverage, but are financed by contributions from national banks alone.

However, despite this proposal having a central role in the original banking union design, it is not clear when, if and how it will be implemented. The current dispute about the

implementation of the EDIS is that some countries, led by Germany, feel that the scheme could lead their banks having to pay for banking problems in other countries. A contentious issue is that national banking systems in some countries are still perceived as being far from sound and that the costs of future bank defaults as a consequence of these legacy issues, let's say in Italy, might be mutualized. A second contentious issue is that rules for prioritizing claims in the case of defaults differ between European countries. While in Germany, in the case of insolvency, most claims are given the same priority, in some other countries wages are paid first from the defaulting bank's assets. For a bank with similar risks and assets, this would lead to higher costs to the EDIS for a bank defaulting in Italy than for a bank defaulting in Germany.

Under the heading of capital market union, the European Commission is trying to harmonize a number of rules on non-credit financial products across the EU to foster alternative financing of companies through venture capital, private equity and new sources such as crowd-funding as well cross-border investment. The hope is that capital markets can substitute for some of the bank financing lacking owing to banking problems, and that a reduction of home bias in portfolios will help bolster asymmetric shocks which hit just one country. The Commission's action plan includes 33 items which are at different stages in the explorative or legislative process.

Evaluation of the reforms

After dissecting the causal factors having contributed to the genesis of the euro crisis and the reforms enacted in

reaction, we can now check how far the crisis causes have been addressed. These results are summarized in table 1. Crisis factors are listed vertically in rows, while reform areas are listed horizontally in columns. A plus sign in a cell signifies that reforms in a certain area have sufficiently addressed the cause in question. A plus sign in brackets means that the problem in question has been addressed, but that there are more or less serious questions about the sufficiency of these reforms.

First, the tightening of fiscal rules clearly addresses the problem of irresponsible fiscal policies. At least from a starting point of sound fiscal policies, the rules now in place should prevent over-indebtedness of governments due to irresponsive spending or insufficient taxation. If anything, the aim of a government budget structurally balanced over the cycle seems to be more strict than necessary. If countries were following this provision, it is difficult to come up with scenarios in which the level of government debt becomes problematic. At least in principle, the enforcement mechanisms (including fines) should also be sufficient to make sure that national governments do not run reckless fiscal policies.

However, there remain some open issues: It is not clear whether the fiscal rules can truly guarantee that euro area countries with an already high level of public indebtedness will move back into the region of clear debt sustainability. While the rules prescribe that the debt-to-GDP ratio has to be reduced annually by 1/20 of the value exceeding 60 percent, macroeconomic logic makes this difficult. Without sufficient economic growth, it is very difficult to bring down the debt level without actual budget surpluses. Yet, trying to achieve budget surpluses by austerity measures when the global economic environment is weak or when an economy

has lost price competitiveness, might simply lower economic growth (and even the level of GDP), hence jeopardizing attempts of bringing down the debt level and even increasing the debt-to-GDP-ratio.

Second, the problem of boom-and-bust cycles has been only partially addressed by the reforms. In principle, the procedures to prevent and correct excessive macroeconomic imbalances should prevent boom-and-bust cycles by forcing national governments to act upon a boom at an early stage, limiting further exuberances. Moreover, it could be hoped that a centralized financial sector oversight helps better to limit excessive lending during a boom. While national banking supervisors often seem to have been captured by their national banks' interest, one could hope that supervisors located within the ECB are more independent and can spot dangerous lending trends more soberly.

These reforms have several problems, though. The first is linked to the procedures to correct macroeconomic imbalances. As a macroeconomic imbalance under EU-methodology is evaluated using a scoreboard plus discretionary judgement, it is not clear whether dangerous trends are sanctioned. Usually, even in cases of strong booms, only some indicators suggest problems. As diagnosing a "macroeconomic imbalance" is at least partly a political process, it is evident that imbalances especially in large (and politically important) member states are not sufficiently tackled, but buried out of the way in the differentiated evaluation of a large number of indicators in the scoreboard.

A second problem is that it is still not clear whether the budget rules are sufficient to prevent pro-cyclical fiscal policy, a factor which contributed to the boom-and-bust cycle in

some of the periphery countries. Especially when countries have a low debt-to-GDP ratio and low deficits, they will continue to be able to run a pro-cyclical expansionary fiscal policy in a boom.

The third problem is linked to banking supervision. While one could of course hope that centralized banking supervision would limit the worst excesses, it is questionable how reliably this can be done. History teaches that in federal systems even centralized supervisory authorities often miss dangerous credit booms, especially if a long period of time has elapsed since the last serious banking crisis. This is linked to the third factor causing the crisis: problems in the banking sector. While the new rules for banking have clearly made banks more secure and the new centralized oversight structure makes a lot of sense, the question remains how dynamically stable these regulations are. Historically, periods without banking crises have regularly led to calls for fresh deregulation which in turn has set the scene for new banking crises. Second, while rules in principle have been tightened, there are still legacy problems in the European banking system. In some countries (such as Italy), banks still have a large share of non-performing loans in their balance sheets and hence are operating with capital adequacy ratios close to the minimum. Even stricter supervision here does not help unless the banks are recapitalized. Yet, banking union is not providing a mechanism to neatly recapitalize ailing banks.

Fourth, the issue of a toxic link between problems in the banking sector and sovereign debt problems has been addressed: The centralized oversight should, it is hoped, prevent serious banking problems from the very beginning. In addition, the prohibition of bank bail-outs with public

money without prior bail-in of private sector funds and the common Single Resolution Fund should help to break the vicious circle of banking problems leading to more government debt and hence more problems because of falling bond prices. However, problems remain: The Single Resolution Fund is only filled over time and only mutualized with a delay. Were a new banking crisis to hit soon and large recapitalizations become necessary, the costs would still mainly weigh on an individual national government, and the financing requirements could still cause concerns about a government's ability to serve its debt that might increase to a level where market access is threatened.

Yet, a related problem is a toxic link between a stagnating economy and the nation's banking sector. Here, weak economic growth leads to an increase in non-performing loans which deter banks from lending which in turn further dampens economic growth. This link is alive and unaddressed, and the failure of having implemented a common deposit insurance might make this problem worse if a banking crisis hits: Under current rules, national deposit insurances are financed by contributions from the national financial sector. If bank failures now cause large compensation payments by a national deposit insurer, this insurer will ask for more contributions from the other banks in its jurisdiction. This is likely to further reduce profitability and the capital buffer of these banks and will lead to continuing weakness in the economy in question. This problem would be mitigated with the introduction of the EDIS.

Fifth, the problem of self-fulfilling market panics has been addressed both with the creation of the ESM and the announcement of OMT by the ECB. Jointly, these two

instruments can be expected to tackle the problem adequately. In the models of self-fulfilling fiscal crises, it is the expectation of high financing costs which drives up expectations of a sovereign default, itself then leading to higher financing costs. If a third party in these models can provide ample loans at low interest rates, there is no reason to expect a default and hence no reason for increasing financing costs. As the ESM, together with the ECB and its OMT, can effectively provide unlimited liquidity to governments in financial dire straits, these two instruments should be able to prevent self-fulfilling fiscal crises in the future. Yet, even though this combination should be enough in principle, is it still open to questions whether OMT will ever be triggered for political reasons as, especially in Germany, this instrument meets strong resistance.

Sixth, the problem of structural divergences of price competitiveness is only partly addressed. For example, under the rules for preventing and correcting macroeconomic imbalances, excessive increases in unit labour costs are monitored. However, given the discretionary character of this exercise (see above) it is questionable if this mechanism is really sufficient to prevent dangerous developments. Moreover, the macroeconomic imbalance procedure is applied in an asymmetric way: For the change in unit labour costs, for example, the scoreboard just prescribes an upper limit, but no lower limit. If one shares the analysis that divergences between euro area countries are the main problem rather than only excessive unit labour increases in some countries, this asymmetric application carries the danger that an important reason for divergences (the undershooting of unit labour costs) is not being addressed. Similarly, current account surpluses are only examined more closely when they

exceed 6 percent of GDP (versus current account deficits which are already more closely examined if they exceed 4 percent of GDP), and so far no action has been taken even in the case of Germany which has been running current account surpluses of more than 8 percent for several years.

Seventh, none of the measures passed has addressed the problem of popular discontent with dismal economic growth and employment outcomes. One can even argue that some of the reforms taken have had an initially negative impact on economic growth. For example, the spending cuts embodied in the new budget rules have dampened economic growth in the short and medium term. Similarly, the increased capital requirements for banks might make banking safer in the medium and long term, but limit lending in the short term which again weighs on economic growth.

There seems to be some hope among Brussels policy makers that the newly proposed capital market union will help to overcome economic stagnation in the euro area. However, there are several problems with this hope. First, it is completely unclear whether investors will really be willing to invest in countries in which the banking system is defunct and banks do not extend adequate credit. Usually, problems in the banking system lead to stagnating economic growth, which in turn also makes equity investments less attractive. Moreover, in the past, international capital flows (also into equity) have been observably very pro-cyclical. Second, problems of asymmetric information and monitoring cost make it questionable whether especially small and medium enterprises will ever be willing to have adequate access to non-credit financing instruments. Even in countries with very developed capital markets such as the United States, SME financing remains a challenge.

Table 1: Causal factors for the euro crisis and reforms addressing these factors

Measures taken / Cause of crisis	Tightened fiscal rules	Procedures for excessive macro-economic imbalances	Lending facilities (ESM)	ECB's outright monetary transactions	Centralized financial sector over-sight	Common bank reso-lution	Overall assessment: Has cause been sufficiently tackled?
Shaky public finances	+						For the future: Yes. But legacy issues remain
Boom-and-bust cycles		(+)			(+)		Probably not
Problems in banking sector		(+)			(+)	(+)	Partly. Legacy issues remain
Toxic link between banks and governments					(+)	(+)	Partly.
Self-fulfilling market panics			+	+			Yes
Structural divergences of price competitiveness		(+)					No
Loss of population's confidence in institutions							No

Note: Empty cells denote that reforms have not addressed a specific cause of the crisis. A "+" means that a reform has addressed a specific cause, a "(+)" means that a reform has addressed a specific cause, but that reservations remain.

To summarize: While a number of issues have been addressed with the reforms of the euro area governance framework since 2010, one can see in the table that important dimensions are still inadequately addressed. Above all, the problems of boom-and-bust cycles, of structural divergences and of the loss of the population's confidence in national and European institutions because of stagnating economic growth and high unemployment have not been sufficiently deal with. Moreover, in other dimensions which in principle seem well addressed by reforms, such as the banking sector, legacy problems remain. Rules in place now should plausibly prevent the deterioration of underlying fundamentals from a sound level to a crisis level.

Overall, the problem is that the rules seem insufficient by themselves to guarantee a return to sound fundamentals and sustained growth. For example, the debt level in some countries remains high and the reforms do not provide a macroeconomic framework to bring the debt-to-GDP-ratio down. Growth remains weak in many parts of the euro area which strengthens anti-EU political forces, yet no set of instruments has been provided to jump start economic growth. In short: Had the rules been in place prior to the run-up to the last crisis, they might have been able to prevent the euro crisis starting in 2010 or at least might have limited its depth. However, they might be insufficient to correct all the problems amassed by almost two decades of growing imbalances and crises.

Conclusion

So, what does all this mean? Seven years of frantic reforms have clearly made the euro area more crisis-proof than it was in 2010. However, it is too early to declare victory over the euro crisis. If one wishes to prevent a (partial) replay of the crisis in the long-run, more work needs to be done, especially to limit divergences, both of the cyclical kind (in national boom-and-bust cycles) as well as of the structural kind. In addition, especially in the short run, it seems paramount that the issue of slow economic growth and high unemployment is addressed to prevent a new round of crisis in which political uncertainty triggers disruptive capital flows and swings in financing conditions. While it is possible that a positive global economic environment and a recovery of the banking sector in countries such as Italy will help the euro area to return to robust economic growth, and that a prolonged growth spell will solve some of the remaining legacy problems as well as the legitimacy issue caused by high unemployment without further changes to the euro area framework, it seems foolish to rely on such an outcome. After all, if the euro crisis erupts again, a break-up of the currency area might quickly be on the cards again, and fighting that crisis might become very expensive indeed.

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An alternative macroeconomic policy approach for the Eurozone*

Eckhard Hein

1. Introduction

The current macroeconomic policy approach in the Eurozone and the institutional setting on which it is based have obviously failed to prevent the global financial and economic crisis of 2007-09 from becoming a euro crisis, on the one hand, and to generate a rapid recovery from these crises in the Eurozone, on the other hand. After the Great Recession of 2008/9, the Eurozone was hit by another downturn in 2012/13, and by 2016 it had only slightly exceeded the level of economic activity before the crisis in 2007, but not at all returned to the pre-crisis growth rate or even growth path

* This contribution is based on previous collaborative work, in particular Hein/Detzer (2015) and Hein/Truger/van Treeck (2012). I would like to thank Christian Jimenez, Franz Prante and Jan Priewe for helpful comments. Remaining errors are exclusively mine.

(European Commission 2016). In several countries, like Spain, Finland, Portugal, Italy and most notably Greece, real GDP is still (considerably) below the pre-crisis level of 2007. Furthermore, several Eurozone member states and the Eurozone as a whole have turned towards the German export-led mercantilist model, running increasing net exports and current account surpluses as a major driver of demand and growth. This risky strategy is contributing to global imbalances and raises severe doubts regarding its sustainability, both economically and politically.

Given this record, the euro crisis cannot be considered to be resolved and a collapse of the single currency is still a major economic and political threat to European integration. Therefore, an alternative economic policy approach to the one which has prevailed since the preparation for and then the introduction of the euro, based on New Consensus Macroeconomics (NCM), needs to be discussed and considered.

In this contribution I will outline such an alternative macroeconomic policy approach, and I will try to link this approach to the existing macroeconomic policy institutions of the Eurozone, i.e. centralized monetary policies but decentralized fiscal and wage policies at the member state level. The reason for this modesty is that I do not expect the most appropriate institutional preconditions for macroeconomic policy-making in a currency union – some sort of United States of Europe with relevant fiscal federalism – to come true in the near future for political reasons. However, as will be seen below, the required shift in macroeconomic policies starting with given institutions is highly demanding, and it requires a serious rethink of the role of aggregate demand management and economic policy coordination in

a heterogeneous currency union like the Eurozone. In order to clarify this, I will start in Section 2 with a discussion of the failure of mainstream New Consensus Macroeconomics applied to the Eurozone that led to the current malaise. Section 3 will then provide a detailed outline of an alternative macroeconomic approach for the Eurozone based on post-Keynesian macroeconomics. Section 4 will briefly summarise and conclude.

2. The failure of New Consensus Macroeconomics applied to the Eurozone

The institutional framework for macroeconomic policies in the Eurozone, the assignment of macroeconomic policy actors and their main strategies have broadly followed the implications and recommendations of mainstream NCM, which had emerged as a synthesis of New Classical and New Keynesian economics at the end of the 1990s (Clarida/Gali/Gertler 1999, Goodfriend/King 1997).

As summarised in Table 1, according to this approach, long-run equilibrium employment and economic activity are given by the NAIRU (Non-Accelerating Inflation Rate of Unemployment), which itself is determined by labour market institutions and the social benefit system affecting the flexibility of nominal and real wages. Since the NAIRU can be understood as an indicator of workers' bargaining power and distributional aspirations, lowering the NAIRU requires liberalization and deregulation of the labour market and 'employment-friendly' adjustments of the social benefit system activating the idle labour force in order

to put competitive pressure on employees and trade unions. This has been the main focus of the European coordination of member state labour market policies, as contained in the Employment Guidelines, the Broad Economic Policy Guidelines, the Lisbon Agenda, the Europe 2020 Agenda, the Country Specific Recommendations of the European Semester, and in the Memoranda of Understanding with the crisis countries.

With the long-run equilibrium unemployment being given by the NAIRU, according to the NCM, inflation targeting monetary policies have to adjust actual unemployment to its equilibrium level by means of raising interest rates when unemployment falls short of the NAIRU and inflation is accelerating and lowering interest rates when unemployment exceeds the NAIRU and inflation is decelerating. Therefore, in the long run, monetary policies will only affect inflation but have no impact on unemployment and economic activity. From this theoretical perspective it follows that the primary long-run objective of the central bank can only be stable inflation, as in the case of the European Central Bank (ECB).

Since long-run employment and economic activity are given by the structural features of the labour market and the social benefit system, and any adjustment towards this long-run equilibrium is delegated to the central bank, there is no macroeconomic role left for fiscal policies in the NCM. Therefore, it has to be ensured that fiscal policies, i.e. government fiscal deficits or surpluses, do not interfere with inflation targeting monetary policies. The NCM hence requires balanced government budgets, at least over the cycle. This is what has been the focus of European coordination of

Table 1: Macroeconomic policy recommendations: New Consensus Macroeconomics (NCM) and post-Keynesian models (PKM) compared

	NCM	PKM
Monetary policy	Inflation targeting by means of interest rate policies, which affect unemployment in the short run, but only inflation in the long run	Target low interest rates affecting distribution, and stabilise monetary, financial and economic sectors applying other instruments (LLR, credit controls, ABRR, etc.)
Fiscal policy	Supports monetary policy in achieving price stability, balances the budget over the cycle	Real stabilisation in the short and long run, no autonomous deficit target, distribution of disposable income
Labour market and wage/ incomes policy	Determines the NAIRU in the long run and the speed of adjustment in the short run, focus should be on flexible nominal and real wages	Affects price level/inflation and distribution, focus should be on rigid nominal wages, steady nominal unit labour cost growth and compressed wage structure
International economic policies	Free trade, free capital flows, flexible exchange rates	Regulated capital flows, managed exchange rates, infant industry protection, regional and industrial policies
Co-ordination	Clear assignment in the long run, co-ordination at best only in the short run	No clear assignment, economic policy co-ordination required in the short and the long run, both nationally and internationally

Notes: LLR: Lender of last resort, ABRR: Asset based reserve requirements

Source: Hein (2016, p. 23)

member state fiscal policies in the Stability and Growth Pact, and it has been further tightened in the course of the euro crisis with the Six-Pack, the Two-Pack, the Fiscal Compact, and the Memoranda of Understanding imposed on the crisis countries. The role left for national governments is then the implementation of those structural reforms in the labour market and the social benefit system which are thought to reduce the NAIRU.

From the NCM a clear-cut assignment and allocation of macroeconomic policy actors, their instruments and their targets can be derived, and there is no need for ex-ante 'horizontal coordination' among monetary, fiscal and wage/incomes policies. The only coordination which is required in this approach is 'vertical coordination' to ensure that fiscal, labour market and wage policies in the member states follow the NCM implications, as outlined above.

These NCM policies applied in the Eurozone have suffered from three major limitations and problems. First, in 'normal' times, i.e. in the period before the crisis, from 1999 until 2007, there was no mechanism which prevented rising current account imbalances and divergence among member states. The one and only Eurozone-level macroeconomic policy instrument, the nominal interest rate set by the ECB for the Eurozone as a whole, exacerbated things, since it could only be guided by Eurozone average inflation. This meant below average real interest rates in booming member countries with above average inflation and rising current account deficits, like Spain, and above average real interest rates in stagnating member states with below average inflation and rising current account surpluses, like Germany. This in turn contributed to even further divergence. Furthermore,

the introduction of structural reform policies in stagnating countries, in order to reduce the respective NAIRU in line with the NCM, further weakened domestic demand in these countries, and thus contributed to stagnation tendencies – and rising current account surpluses due to the dampening effect on imports, in particular in Germany.

Second, when the Great Recession hit the Eurozone as a whole in 2008/9, it became clear that nominal interest rate policies by the ECB were insufficient to stabilise aggregate demand and economic activity. There are several well-known reasons for that. There is the zero lower bound for the nominal short-term ECB lending rate, the main refinancing rate, which imposes a downward constraint on interest rate policies. Furthermore, lowering the short-term policy rate in a deep recession with rising uncertainty and rising default risks, and hence with increasing risk and liquidity premia for commercial banks and other financial intermediaries, will not be sufficient to bring down long-term interest rates, which are important for investment decisions. And finally, even if central banks manage to reduce long-term interest rates, i.e. by means of direct intervention in financial markets ('quantitative easing'), this is not sufficient to stimulate investment under the conditions of depressed demand expectations, since it is like 'pushing on a string'.

Third, and the main reason why the financial crisis and the Great Recession turned into the euro crisis in 2010, the role of the ECB as a 'lender of last resort', not only for the banking sector, but also for member state governments, was unclear at the beginning of the crisis. Therefore, when governments went into debt in order to stabilise the financial sector, and also the real economy when the limits of

ECB monetary policies became obvious, some interest rates on member state debt started to rise and put these governments under the pressure of financial markets, in particular in Greece, Ireland, Portugal, and then also in Spain and Italy. As a consequence, the ECB gradually moved towards becoming a lender of last resort and guarantor of government debt of member states. The major step, of course, was taken when the President of the ECB, Mario Draghi, in 2012 announced that "(w)ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro". However, this was later on qualified such that the ECB's willingness to intervene in secondary government bond markets, in the context of Outright Monetary Transactions (OMT), was made conditional on the respective countries applying to the EFSF/ESM and introducing macroeconomic adjustment programmes, i.e. austerity policies. Linking financial rescue measures with austerity policies, however, is detrimental to recovery in the crisis countries, because it makes a recession worse and leads to (the threat of) deflationary stagnation, and it undermines the intended reduction of government debt-GDP ratios (De Grauwe 2012, Hein 2013/14).

3. A post-Keynesian economic policy proposal for the Eurozone

An alternative macroeconomic policy approach for the Eurozone will have to address and tackle the three areas of limitations and problems of the NCM applied in the Eurozone. Such an alternative can be based on the post-Keynesian macroeconomic policy approach (Arestis 2013,

Hein/Stockhammer 2011), which is summarised in Table 1. Following the post-Keynesian view, economic activity and employment are determined by effective demand, both in the short and in the long run. Each area of macroeconomic policy making has a direct or indirect effect on effective demand and employment, and therefore ex ante 'horizontal coordination' among monetary, fiscal and wage policies is of utmost importance, as is the 'vertical coordination' of decentralised member state policies in the areas of fiscal and wage policies in the case of the Eurozone. And these coordinated demand management policies will have to be supplemented by effective regional and industrial policies in order to facilitate the sustainable catch-up of the Eurozone periphery with respect to the core countries. In principle, the European Union and the Eurozone have developed some required institutions for this purpose, with the Macroeconomic Dialogue, the European Semester and the financing institutions for regional and industrial policies, such as the European Investment Bank (EIB) and the European Investment Fund (EIF). However, this institutional framework needs to be linked with a new approach towards macroeconomic and development policies, as will be explained below.

3.1 Monetary policy

According to the modern post-Keynesian approach, central bank interest rate policies should abstain from attempting to fine-tune unemployment in the short run and inflation in the long run, as suggested by the NCM. Interest rate variations have cost and distribution effects. Therefore, central

banks may be effective in stopping accelerating inflation in the short run by raising the short-term nominal rate of interest, which will trigger rising long-term rates, finally choking investment and stopping the economic boom. However, in the long run, surviving firms will have to face higher interest rates, which will feed distributional conflict and hence inflation again, because firms will have to cover these rising interest costs. Furthermore, in the case of a recession with falling inflation rates, and possibly deflation, central bank interest rate policies will be ineffective in stimulating the economy in the short run as has been explained in the previous section.

Therefore, central banks, and hence the ECB, should focus on targeting low real interest rates in financial markets, in order to avoid unfavourable cost and distribution effects on firms and workers. A slightly positive long-term real rate of interest, below the long-run rate of productivity growth or real GDP growth, seems to be a reasonable target. Real financial wealth will be protected against inflation, but redistribution of income in favour of the productive sector will take place, which should be favourable for investment, employment and growth. Furthermore, central banks have to act as a 'lender of last resort' during liquidity crises and should be involved in the regulation and supervision of financial markets using other tools than the short-term interest rate. These can include the definition of credit standards for refinancing operations with commercial banks, the implementation of reserve requirements for different types of assets, and even credit controls in order to channel credit into desirable areas and to avoid credit-financed bubbles in certain markets.

Most importantly, the ECB should not only act as a lender of last resort for the banking system, but also unconditionally guarantee the public debt of Eurozone member states. The ECB as a lender of last resort for member state governments would allow these governments to issue debt in their 'own currency' again, and it would thus reduce the pressure imposed by financial markets. The ECB could simply announce that it will intervene unconditionally in secondary government bond markets and provide unlimited liquidity, as soon as the government bond rate of a specific country exceeds the risk-free rate – which is considered to be the rate on German government bonds – by 200 basis points, as De Grauwe (2013) has proposed. I would propose a more country-specific solution: The ECB should announce it will intervene in secondary government bond markets as soon as the nominal rate of interest on government bonds exceeds the medium-run nominal GDP growth rate of the respective country. This would imply country-specific caps on nominal interest rates on government bonds and, to the extent that government bond yields are considered as a benchmark, also for long-term interest rates in the respective countries in general. This should provide the conditions for fiscal policies of the member states to stimulate aggregate demand for the Eurozone as a whole and to contribute to internally rebalancing the Eurozone.

3.2 Wage and incomes policy

In a post-Keynesian macroeconomic policy mix, wage and incomes policies should accept responsibility for nominal

stabilisation in particular, that is for stable inflation rates. Nominal wages should hence rise according to the sum of long-run average growth of labour productivity in the national economy plus the target rate of inflation for the Eurozone as a whole. Following such a wage norm in each of the member states would contribute to equal inflation rates across the Eurozone, and it would prevent mercantilist strategies of individual countries based on nominal wage moderation.

In order to contribute to the rebalancing of current accounts within the Eurozone at high levels of economic activity by means of re-adjusting relative price competitiveness, wage policies for an intermediate period of time would have to deviate from the norm outlined above. Nominal wage growth in current account surplus countries would have to exceed the norm, whereas nominal wage growth in deficit countries would have to fall short of this norm, however, without triggering deflation in these countries.

To achieve the nominal wage growth targets, a high degree of wage bargaining co-ordination at the macroeconomic level, and organised labour markets with strong trade unions and employer associations seem to be necessary conditions. Government involvement in wage bargaining may be required, too. In particular, Eurozone-wide minimum wage legislation could be helpful for nominal stabilisation at the macroeconomic level, apart from its usefulness in terms of containing wage inequality. The European Trade Union Confederation has recommended setting the minimum wage at a level of at least 50 per cent of the average wage or 60 per cent of the median wage in the respective member countries (Schulten 2012). This legal minimum wage would then have to rise according to the rules explained above.

Furthermore, legal extensions of wage bargaining agreements throughout an entire industry or sector and other extension mechanisms, as well as public sector bargaining setting the pattern for private sectors, could be helpful for effective wage bargaining coordination.

Although wage bargaining coordination across the Eurozone will have some merits in terms of reducing inequality within member countries, preventing further downward pressures on labour income shares exerted by competitive wage policies and beggar-thy-neighbour strategies, and in terms of harmonising inflation rates in the Eurozone, there will be only limited effects on current account imbalances within the Eurozone. As has been briefly reviewed in Hein/Detzer (2015), several empirical studies based on different models and methods have found that the current account imbalances within the Eurozone have mainly been driven by non-price competitiveness and growth differences, and only to a lesser degree by diverging price competitiveness. This implies that the major burden for internally rebalancing the Eurozone should fall on fiscal policies in the short run, stimulating domestic demand in current account surplus countries in particular, and on structural and regional policies in deficit countries, improving their non-price competitiveness in the medium to long run.

3.3 Fiscal policy – and the role of European industrial and regional policies

In a post-Keynesian coordinated macroeconomic policy mix, fiscal policies should assume responsibility for real

stabilisation at non-inflationary full employment levels of economic activity and also for a more equal distribution of disposable income. Through these functions, fiscal policies can also contribute to rebalancing the Eurozone internally. Let me start with the aggregate role of stabilisation. From national accounting we know that ex post the excess of private saving (S) over private nominal investment (I) at a given level of economic activity and employment has to be absorbed by the excess of nominal exports (X) over nominal imports (M) (including the balance of primary income and the balance of income transfers, thus the current account balance) plus the excess of government spending (G) over tax revenues (T): S-I = X-M+G-T. Therefore, with balanced current accounts (X-M = 0), government deficits in the medium-run perspective have to permanently take up the excess of private saving over private investment (G-T = S-I) in order to maintain a desired level of economic activity and employment, following the functional finance view pioneered by Lerner (1943). Of course, if the private sector is in deficit and the current account is balanced, the government sector has to be in surplus.

From Domar (1944) we know that with a constant government deficit-GDP ratio, the government debt-GDP ratio will converge towards a constant value, which is given by the quotient of the government deficit-GDP ratio and nominal GDP growth, provided that the latter is positive. Furthermore, nominal interest rates falling short of nominal GDP growth and hence of tax revenue growth will prevent government debt services from redistributing income from the average tax payer to the rich government bond holders, which would be detrimental to aggregate demand

and growth. That is why targeting low interest rates on government bonds by the central bank is very important.

Permanent government deficits should be geared towards public investment in a wider sense (including growth-enhancing public employment), providing the economy with public infrastructure and public education at all levels (pre-schools, schools, high schools, universities) in order to promote structural change towards an environmentally sustainable long-run growth path. Apart from this permanent role of government debt, which also supplies a safe haven for private saving and thus stabilises financial markets, counter-cyclical fiscal policies – together with automatic stabilisers – should stabilise the economy in the face of aggregate demand shocks.

Furthermore, governments should apply progressive income taxes and adopt relevant wealth, property and inheritance taxes, as well as social transfers, which aim at redistribution of income and wealth in favour of low income and low wealth households. On the one hand, this will reduce the excess of private saving over private investment at non-inflationary full employment levels and thus stabilise aggregate demand. Progressive income taxation and relevant taxes on wealth, property and inheritance thus also reduce the requirements for government deficits. On the other hand, redistributive taxes and social policies will improve automatic stabilisers and thus reduce fluctuations in economic activity and the required scale of short-run stabilising fiscal policies.

Applying this general approach to the Eurozone requires a revamped Stability and Growth Pact for the coordination of national fiscal policies, which should focus on medium-run expenditure paths for non-cyclical government spending,

and thus a variable which member state governments can indeed control (Hein/Truger/van Treeck 2012). The sum of these expenditure paths should be geared towards stabilising aggregate demand in the Eurozone at non-inflationary full employment levels. This full employment level of economic activity should be associated with a balanced current account with the rest of the world, abandoning the current tendency towards an export-led mercantilist regime in the Eurozone. For each Eurozone member state this would mean that, on average over the cycle and with the medium-run net tax rate in each member country given, the path for non-cyclical government expenditure should be targeted at generating a medium-run or 'structural' government deficit/surplus, balancing the medium-run or 'structural' private sector surplus/deficit at high levels of non-inflationary employment and a roughly balanced current account of the member states. Automatic stabilisers plus discretionary counter-cyclical fiscal policies could then be applied to fight short-run demand shocks.

Instead of the current 'one-size-fits-all' coordination with respect to target or maximum government deficit- and debt-GDP ratios, this new type of coordination of fiscal policies contains country-specific medium-run target government deficit-GDP ratios, given by the medium-run national private sector financial balances. It would also lead to country-specific government debt-GDP ratios, depending on the respective government deficit-GDP ratios and the nominal GDP growth trends. The expenditure paths for non-cyclical public sector spending of each member country should be coordinated and monitored by the European Commission in the context of the European

Semester, and unwillingness to correct deviations should be sanctioned. Ultimately, if member states persistently exceed their country-specific target deficit-GDP ratios, triggering rising national inflation and current account deficits, and if they are unwilling to correct this in the face of fines imposed by the European Commission and the Council of Economic and Finance ministers (Ecofin), the ECB could temporarily suspend its readiness to intervene in the secondary government bond markets of the relevant countries. The threat of rising interest rates on government bonds of the respective countries should induce them to come back to the expenditure path consistent with coordinated fiscal policies in the Eurozone. If mature member states persistently fall short of their country-specific government deficit-GDP ratios, triggering current account surpluses, the relevant fines imposed by the European Commission and the Ecofin should be used for European investment projects, with a focus on the catch-up periphery countries.

Following these recommendations for coordinated fiscal policies should boost aggregate demand for the Eurozone as a whole, and it should also contribute to internally rebalancing the Eurozone and prevent increasing current account imbalances in the future. Current account surplus countries would have to apply more expansionary fiscal policies than before and since the crisis, in order to increase domestic demand growth. Together with the temporary acceptance of higher than Eurozone average inflation rates, this should reduce their current account surpluses and reduce the current account deficits of the counterpart deficit countries through the stimulation of their exports. Current account deficit countries would have to reduce inflation in the short run,

without driving the economy into deflation and recession, of course. And most importantly, in the medium run, these countries should aim at improving their non-price competitiveness, decreasing the income elasticity of their imports and increasing the income elasticity of their exports, by means of industrial, structural and regional policies.

The latter should be integrated within a European industrial and regional policy strategy aiming at the sustainable catch-up of the periphery with respect to the core. For such an adjustment process, perfectly balanced current accounts between member states cannot be expected and, therefore, the rules for fiscal policy co-ordination outlined above would have to be modified. Catch-up countries will and should have a persistent tendency to grow faster than the more mature countries, which, *cet. par.*, will make their imports grow faster than their exports. Therefore, with the Eurozone as a whole running a balanced current account with the rest of the world, internally there would be a tendency for catch-up member countries to run current account deficits, and for more mature countries to run current account surpluses. These current account deficits and surpluses should be tolerated and taken into account in the coordination of fiscal policies. Target medium-run public sector financial balances in the catch-up countries can hence be somewhat lower than implied above, and target medium-run public sector financial balances of mature countries can be somewhat higher. The pre-condition for this is, of course, that higher growth in the catch-up countries can be sustained – and is not driven by financial or housing market bubbles as in the past. Therefore, the direction and the use of the capital inflows into catch-up current account deficit

countries should be part of an integrated European industrial and regional development strategy for the periphery. This should include the efficient regulation of and intervention in capital flows to avoid bubble growth, on the one hand, and 'high road' development strategies, on the other hand, making use of public investment, both national and European, in infrastructure and education, as well as public development banks and funds (i.e. EIB, EIF, etc.) to support private investment in the respective countries.

4. Conclusions

Starting from the observation that the mainstream macroeconomic policy approach based on the NCM has badly failed in the Eurozone, both in terms of preventing the global financial and economic crisis from becoming a euro crisis and in generating a rapid recovery from the crisis, I have outlined the elements of an alternative macroeconomic policy approach for the specific institutional setup of the Eurozone based on post-Keynesian macroeconomics. This policy approach should address the main problems of the NCM approach before and during crises. It is able to deal with tendencies of divergence and imbalances within the Eurozone, it provides the tools to deal with short- and long-run aggregate demand problems, and it contains a solution for the lender of last resort and guarantor of government debt problem which has triggered the euro crisis. For this approach to become relevant, what policy makers in the Eurozone would have to accept and take on board is the need for aggregate demand management,

both at the Eurozone and at member state levels, and for coordination of macroeconomic policies, between the ECB, the Ecofin and the European trade unions and employer associations, as well as the integration of macroeconomic policies with industrial and regional policies so as to facilitate the successful catching up by the European periphery. In moving towards such an approach and contributing to the survival of the Eurozone in the short run, it is most important to break the link between the ECB's stabilisation of member countries' government bond yields, on the one hand, and the required austerity policies in the crisis countries, on the other hand. This should allow these countries, and the Eurozone as a whole, to apply more expansionary fiscal policies in order to accelerate the recovery process, as well as providing the economic and political conditions for further reforms.

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Fixing the Euro's Original Sins: The Monetary – Fiscal Architecture and Monetary Policy Conduct

Thomas Palley

1. The euro's twin original sins

The euro is afflicted by twin original sins: rupture of the money – fiscal policy link and adoption of neoliberally designed monetary policies. Those twin sins have contributed to generating dismal economic outcomes, which have fostered ugly political conditions that echo the 1930s and risk causing the euro to disintegrate.

This paper shows the euro's twin original sins can be fixed in a politically viable manner. As regards economics, the euro is a monetary phenomenon, which means that getting the monetary architecture right is the *sine qua non* for success. Other economic policy adjustments can then further strengthen euro zone (EZ) economic performance,

but without the right monetary architecture economic success will inevitably prove elusive.

As regards politics, the fundamental problem is the EZ consists of national political sovereigns that have been required to surrender monetary sovereignty. However, those national political sovereigns need a degree of monetary sovereignty in order to defend their public finances and pursue expansionary fiscal policy in times of economic distress. The EZ's architecture makes little provision for this, because of a combination of fears of moral hazard from country bail-outs and intellectual blindness. Fixing the EZ's monetary architecture and restoring a degree of monetary sovereignty is essential for creating the policy space needed by national governments to make the euro politically viable.

2. Diagnosing the EZ's problems

The euro was introduced in January 1999. As shown in Table 1, the EZ's macroeconomic performance was barely satisfactory prior to the financial crisis of 2008, but it has been dismal since. Since peaking in the 1960s, EZ average GDP growth each decade fell steadily through the 1990s. The introduction of the euro saw a brief uptick, but growth has collapsed since the 2008 financial crisis. That story is mirrored in the unemployment rate which steadily increased through to the 1990s, then fell slightly with the euro's advent, but surged to sustained record highs after the financial crisis.

Table 1. EZ output growth and unemployment rate.

	Region	1961-70	1971-80	1981-90	1991-98	1999-2008	2009-2015
Average GDP growth rate at 2010 market prices (%)	EZ-12	5.3	3.4	2.4	1.9	2.1	0.1
	EZ-19					2.1	0.1
Average unemployment rate (%)	EZ-12	2.3	4.0	8.5	10.0	8.5	10.8
	EZ-19					8.7	10.8

Source: Statistical Annex of the European Economy, Spring 2016 (Tables 3 and 10) plus author's calculations.

Behind this data is a dismal economic policy history. That history begins with the adoption of tough anti-inflation policy in the late 1970s, which turned into neoliberalism in the early 1980s. Consequently, Europe never fully recovered from the dislocations of the 1970s. The neoliberal turn was further locked in place in the 1990s with the first steps to monetary union via the Maastricht Treaty and its imposition of strict EZ economic convergence criteria, requiring a deflationary policy posture to meet them. Come the euro, there was a brief boom in the 2000s fueled by the intersection of low interest rates and speculation. However, when the bust arrived with the 2008 crisis, the design flaws in the euro's monetary architecture and policy conduct surfaced with a vengeance. Those flaws are systemic and remain largely unresolved. Consequently, they now pose an existential threat to the euro.

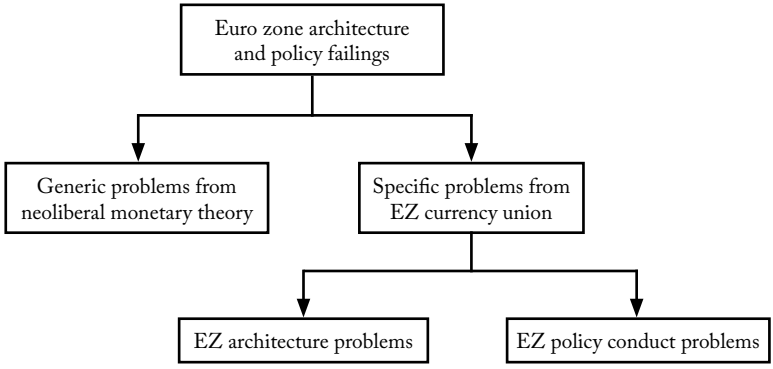
The weakness of the EZ's economic performance is significantly rooted in its monetary architecture and monetary

policy conduct. As regards architecture, the design of the euro's monetary policy institutions has massively shrunk the space for national fiscal policy and also exposed government finances to market instability. Under the old system of national currencies, each country government had a central bank that acted as the "government banker". Thus, national central banks helped governments finance their budget deficit, and also defended government bonds against speculative attack. This government banker function was completely and mistakenly ignored by the euro's creators, thereby weakening governments' ability to finance fiscal policy and giving financial markets massive power over them (Palley, 2011a, 2011b).

Simultaneously, EZ monetary policy conduct has been sub-optimal. It was blind to asset price bubbles before the crisis; was slow to respond in the crisis; and the two percent inflation target risks being an unnecessary brake on performance if the EZ escapes the current stagnation.

Figure 1 outlines the nature of the problem. It decomposes the challenge of EZ monetary reform into generic problems related to the neoliberal construction of monetary policy, and specific problems concerning the euro as a currency union. The currency union problems are then further decomposed into architecture problems and conduct of policy problems.

Figure 1. A diagnosis of the failings afflicting the EZ's monetary architecture and policy.



3. New Classical economics and the origins of the euro zone's monetary architecture and policy failings.

To understand the EZ's failings and the case for reform, it is necessary to begin with new classical economics which inspired and underlies the EZ's architecture and policy conduct. New classical macroeconomics (i.e. Chicago School macroeconomics) has under-pinned neoliberal economic policy, and it asserts:[1]

A) Money and inflation are neutral and have no effect on the real economy;

B) Inflation is caused exclusively by money supply growth;

C) The real economy automatically and quickly returns to full employment in response to negative shocks via price and nominal wage adjustment;

D) Financial markets are efficient and stable and determine a natural interest rate that delivers full employment;

E) Fiscal policy is ineffective.

Given the above theoretical framework, optimal policy involves having an independent central bank implement a credible transparent interest rate rule aimed at targeting stable low inflation. According to the policy rule, the equilibrium short-term interest rate should equal the inflation target plus the estimated natural real rate of interest. Furthermore, inflation targeting, implemented via the interest rate rule, is all that is needed to secure full employment because the economy goes there automatically and quickly.

This view of economic theory and optimal policy was hegemonic in the 1990s when the euro was designed and implemented, and it remains hegemonic today – albeit with less self-confidence. Its hegemonic standing meant that Social Democrats (like Jacques Delors and Wim Duisenberg) also accepted it. Consequently, it provided the theoretical template for designing the euro zone's architecture and policy conduct.

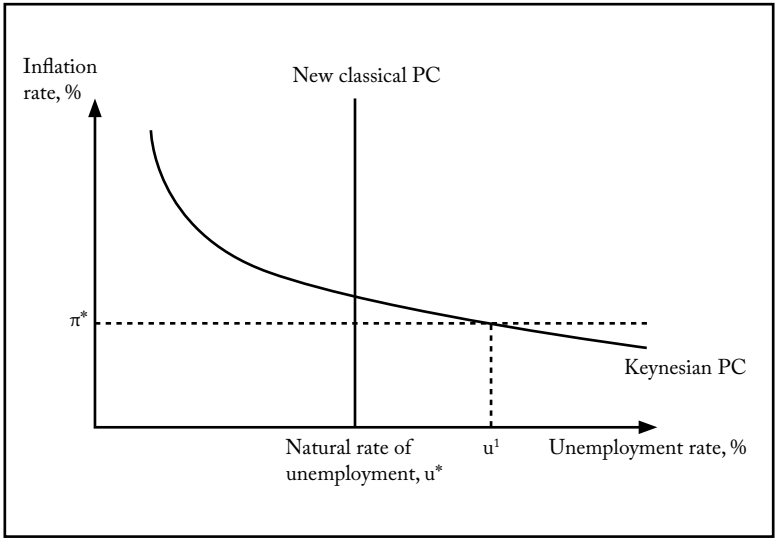
3.a) Generic problems of new classical monetary policy

The new classical construction of monetary policy and central banking produces three grave generic problems that have afflicted monetary policy in both Europe and elsewhere. The first problem concerns mistakenly low inflation targeting. The problem stems from Milton Friedman's (1968) natural rate of unemployment hypothesis which claims money and inflation have no permanent real effects. Consequently, there is no trade-off between inflation and unemployment so that the long-run Phillips curve is vertical. This contrasts with

the Keynesian view that a trade-off exists and the Phillips curve is negatively sloped because modest inflation helps grease the wheels of labor market adjustment (Tobin, 1972; Palley, 1994, 2012).

Figure 2 shows the new classical and Keynesian Phillips curves. Neoliberal macroeconomics recommends an ultra-low inflation target (π^*). The argument is that inflation is undesirable and confers no unemployment gain because the economy always gravitates to the natural rate of unemployment (u^*). From a Keynesian perspective, that will cause significant unnecessary unemployment as inflation of π^* implies a higher unemployment rate ($u^1 > u^*$) according to the Keynesian Phillips curve.

Figure 2. New classical (neoliberal) vs. Kensian Phillips curves.



A second generic problem concerns central bank support for the so-called "labor market flexibility agenda" which aims to diminish workers' rights, protections and bargaining power. Natural rate theory argues the natural rate of unemployment is determined by frictions and rigidities within the labor market. Those frictions and rigidities are argued to include trade unions, minimum wages, unemployment insurance, and worker rights and protections. Since central banks believe in natural rate theory, that explains why they have persistently and vigorously lined up in support of the "labor market flexibility agenda" which has contributed to wage stagnation and increased income inequality.

The third generic problem of neoliberal economics is its belief that "flexible" labor markets and interest rate policy, targeted on low stable inflation, are all that is needed to secure full employment. This belief stems from the assumptions of new classical economics about the economy's adjustment capacities and the character of financial markets. The important implication is it predisposes central banks against the need for financial market regulation or the need to intervene in asset markets to address asset price bubbles (Palley, 2003, 2006a). It also explains the retreat from and resistance to quantitative monetary policy (e.g. regulation of the asset side of banks' balance sheets), which was an important component of policy in the "golden age" three decades after World War II.

3.b) EZ monetary architecture problems: the rupture of the money – fiscal policy link

The major monetary architectural problem of the EZ concerns its divorce of the monetary authority from national fiscal authorities (Goodhart, 1998). From a new classical perspective, this divorce is inconsequential because fiscal policy is ineffective and increases in the money supply only cause inflation. Consequently, there is no need for money-financed fiscal policy and a hard divorce of the monetary and fiscal authorities is desirable.

According to new classical economics, if governments want to run budget deficits they should compete for finance with the private sector in financial markets. That is the efficient way to allocate capital. Additionally, in the context of a currency union, divorce of the monetary and fiscal authority is needed to prevent fiscal moral hazard. If member countries know the central bank will step in and finance their deficits, that would provide an incentive for countries to run larger and larger deficits.

The divorce of the monetary authority (i.e. the central bank) from the fiscal authority (i.e. the national state) is predicated on the assumptions that fiscal policy is ineffective, money financed deficits only cause inflation, and financial markets are stable and efficient. Once those assumptions are rejected, the new classical monetary architecture becomes dangerously dysfunctional.

The loss of national central banks and the divorce between monetary policy and fiscal policy leave national governments dependent on financial markets for their budget deficit financing needs. Consequently, governments may be unable

to finance needed expansionary fiscal policy (Goodhart, 1998). Additionally, financial markets will have the power to veto fiscal policy via bond market sell-offs, and governments will also lack the means (i.e. a central bank under their control) to intervene and stabilize national financial markets in the event of financial panic (Palley, 1997). That is exactly what has happened in the EZ after the financial crisis of 2008.

3.c) EZ monetary policy conduct problems: too low an inflation target

As regards the conduct of EZ monetary policy, the generic policy problem of excessively low inflation targeting is amplified in a currency union (Palley, 1997, 2006b). This is illustrated in Figure 3. For new classical economists, a non-optimal currency union may increase the natural rate of unemployment for the currency union as a whole ($u^*_{PRE} < u^*_{POST}$). However, from their perspective, there is no cost in sticking with the pre-existing inflation target since monetary policy cannot affect the new natural rate of unemployment. In sharp contrast, a Keynesian perspective counsels differently. The Phillips curve shifts right from KPC_{PRE} to KPC_{POST}, so that preventing further increased unemployment requires the currency union to adopt a higher inflation target. If the target is unchanged and held at π^* after monetary union, the unemployment rate will rise to $u^2 > u^1$.

Additionally, the higher unemployment caused by the EZ's low inflation targeting problem has been further

compounded by the fact that Germany's Bundesbank monetary policy was adopted as the template for the euro. The Bundesbank has long been dominated by monetarist thinking that is staunchly opposed to inflation. Its monetarist approach was imported into the ECB in the form of an inflation target mandating less than 2 percent inflation. In effect, the creation of the euro was used to lower the EZ's overall inflation target ($\pi_{POST} < \pi_{PRE}$) as shown in Figure 4. That caused an even larger increase in EZ unemployment to $u^3 > u^2$.

Figure 3. The effect of currency union on the Phillips curve.

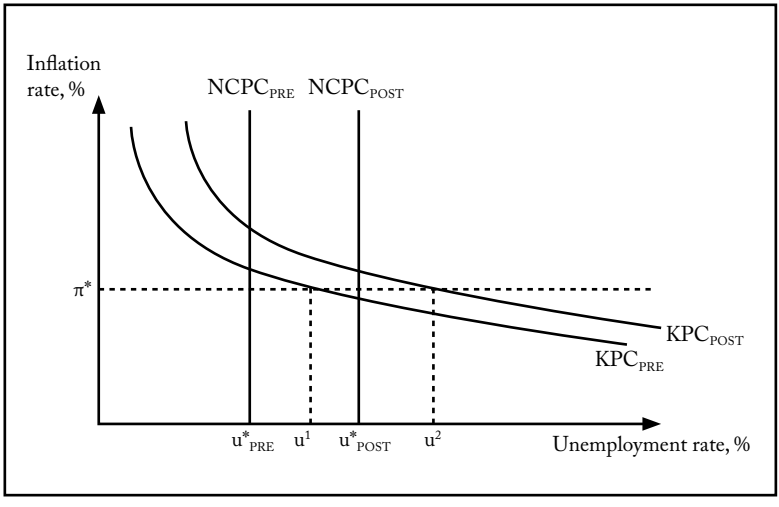
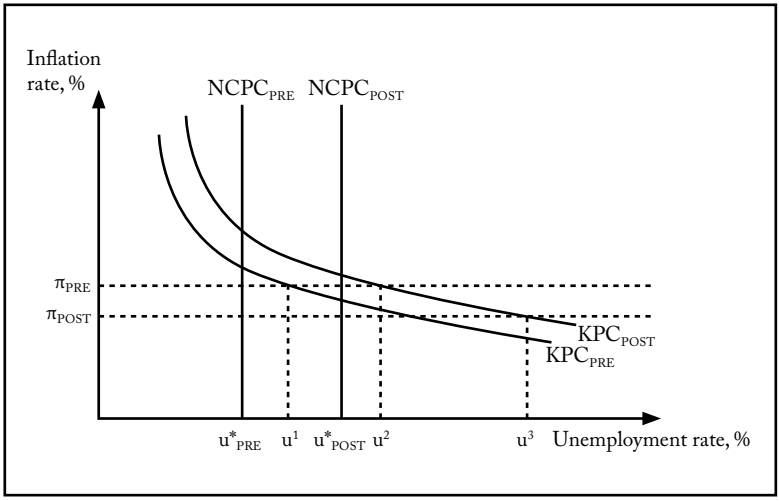


Figure 4. The effect of adopting the Bundesbank's ultra-low inflation target



In sum, from a Keynesian perspective, not only did monetary policy fail to raise the inflation target to combat higher unemployment caused by monetary union creating a more diverse economy with more dispersed economic outcomes, it lowered the inflation target for many member countries which had higher targets prior to the euro. That made for a double failure in the conduct of monetary policy.

4. The crisis and the failure of neoliberal economics

The financial crisis of 2008, the Great Recession, and the ensuing stagnation should have entirely discredited neoliberal economics. These events have shown financial markets can be unstable and can greatly misprice assets; economies do

not automatically and quickly rebound to full employment; fiscal policy can be highly effective; and inflation is not exclusively and automatically generated by money supply growth. That speaks to remaking the EZ's monetary architecture and redesigning the conduct of monetary policy as events have shown the current architecture and policy design are founded on flawed theory.

5. Remedying the EZ's monetary architecture and monetary policy

5.a) Repairing the money – fiscal policy link via a financing union

The euro's divorce of the monetary and fiscal authorities has created grave problems for governments' ability to finance fiscal policy and defend against financial market speculators. The conventional wisdom is the EZ needs "fiscal union" to overcome these architectural failings, but EZ countries do not politically want that. Instead, I (Palley, 2011a, 2011b, 2016) have argued for a "financing union" that involves collective issuance of debt, the proceeds of which are distributed among members on a per capita basis.

A financing union would require establishment of a European Finance Authority (EFA) governed by the finance ministers of euro zone countries. The Finance Authority would issue bonds jointly and severally backed by all member countries, which the ECB could buy.

The Authority would engage in no spending, and would simply pay issue proceeds to member countries on a per capita basis, with countries liable for debt service on the

same per capita basis. Each year the EFA would determine the appropriate budget deficit for the euro zone, issue bonds, and distribute the proceeds to member countries to use as they deemed fit.

Those countries wanting fiscal stimulus could spend the proceeds: others could use them to buy EFA bonds, thereby covering their obligation and leaving their net debt position unchanged.

Countries could also issue their own national bonds to finance additional stimulus over and above that financed by EFA, and these national bonds would constitute a form of junior national debt. Lastly, an accompanying bankruptcy mechanism would be established. Country national debt would be subject to a junior bankruptcy mechanism similar to the Chapter 9 provision in US law for states and municipalities. EFA debt would be subject to a senior sovereign bail-out mechanism that could permit conditionality arrangements.

The financing union proposal has many significant advantages, but three stand out. First, it permanently remedies the euro's original sin, creating both a permanent policy mechanism for deficit financing and a bond that can be bought without qualification by the ECB. Second, it avoids the great political pitfall of fiscal unions regarding usurping control of the purse from the state or imposing transfers between countries. Countries choose how they spend EFA proceeds. Third, it reconnects money and the state without creating fiscal moral hazard as countries are not bailed out by the EFA or ECB.

5.b) Conduct of monetary policy: a higher inflation target

With regard to conduct of monetary policy, the first change should be a higher inflation target in the region of 3 – 5 percent. Some mainstream economists (Blanchard et al., 2010) are also moving in this direction. Their argument is that a higher equilibrium inflation rate is needed to raise nominal interest rates, thereby providing space for the central bank to lower interest rates if the economy gets in trouble.

Such support is welcome, even if the reasoning is stuck in failed monetary theory. However, it would be far better if the Keynesian Phillips curve rationale were adopted as that would also bury the natural rate of unemployment hypothesis. As long as central banks hold to that hypothesis, there will be a perennial risk that central banks are drawn back into actively supporting the mistaken and damaging labor market "flexibility" agenda.

5.c) Conduct of monetary policy: target the bond rate on newly issued EFM bonds.

A financing union would create a steady growing supply of EFA bonds, and the ECB could then target the long bond rate as well as set the short-term interest rate. Neoliberal monetary theory recommends targeting just the short-term interest rate. The assumption is the combination of efficient financial markets plus a credible transparent interest rate rule ensures current long term interest rates reflect expectations of future short-term interest rates. Consequently, there is no need to target the long rate.

Such indirect management is unreliable and imprecise as it rests on markets having correct expectations and understandings of future policy. The behavior of financial markets should have punctured that belief long ago. In future, rather than relying on market expectations to determine long rates, the ECB should directly target long rates using EFA bonds as the benchmark (Palley, 2013).

5.d) Asset based reserve requirements (ABRR)

Interest rate targeting should be supplemented by a system of ABRR which would extend margin requirements to a wide array of assets held by financial institutions (Palley, 2000, 2003, 2004, 2006b, 2010). ABRR require financial firms to hold reserves against different classes of assets, with the regulatory authority setting adjustable reserve requirements on the basis of its concerns with each asset class. One concern may be that an asset class is too risky; another may be that an asset class is expanding too fast and producing inflated asset prices.

A system of ABRR that covers all financial firms has multiple policy benefits. Most importantly, it enables central banks to target sector imbalances without recourse to the blunderbuss of interest rate increases. For example, if a monetary authority was concerned about a house price bubble generating excessive risk exposure, it could impose reserve requirements on new mortgages. This would force mortgage lenders to hold some cash to support their new loans, raising the cost of such loans and cooling the market.

For the EZ, ABRR are additionally attractive because they can help address the policy instrument gap at the national

level created by the euro's introduction (Palley, 2006b). That can be done by implementing ABRR on a geographic basis. For instance, requirements on new mortgage loans can vary by country, or even by region within countries.

5.e) Banking union

Just as the design of the EZ neglected fiscal policy and the need for a government banker, so too it neglected the problem of cross-country bank runs (as has happened with money fleeing from the EZ periphery crisis countries to Germany).

The ECB's TARGET 2 balance system has plugged the hole by making liquidity available to banks losing deposits. However, it is an inefficient system that recycles liquidity *ex-post* rather than preventing its flight *ex-ante*. It also creates banking regulatory moral hazard across countries, since countries know their banks have access to emergency liquidity from the ECB. That speaks to the need for full banking union with deposit insurance and common regulatory standards and capital requirements for bank asset and liability structures.

6. Radical reform of central bank thinking: bring back pluralism and Keynesianism.

Lastly, there is a need for profound and radical reform of ECB thinking and practice. Over the last three decades, central banks have been arrogant, with closed minds, ignoring all economists outside their narrow sociological

circle, and dismissing all who disagreed with their belief that low inflation targeting was sufficient. Events have proved central bank economists wrong and shown the assumptions of neoliberal monetary theory to be disastrously flawed.

In contrast, the Keynesian critics got things substantially right. Godley (1992) argued the euro had a blind spot regarding the need for a European federal institution to undertake counter-cyclical fiscal policy. Goodhart (1998) identified the dangers for financing fiscal policy of divorcing the monetary and fiscal authorities.[2] Palley (1997) argued this divorce gives bond markets the power to discipline governments that pursue economic policies which markets dislike. Additionally, Palley (1997, 2003, 2006a, 2006b) argued for both a higher inflation target and the need for quantitative monetary policy and ABRR to supplement interest rate inflation targeting policy, thereby giving member countries additional policy instruments to replace those lost owing to currency union.

The superior record of Keynesians, regarding understanding the monetary macroeconomics of currency unions and anticipating the problems of the euro, suggests it is time to heed them by reforming the EZ along the lines they have advocated. It is also time to break the new classical monopoly on monetary theory and policy and open central banking to Keynesian ideas – and Keynesian economists.

Notes

1. Though somewhat more caveated today, new classical macroeconomics remains mainstream economists' dominant theoretical frame, which

explains their incapacity to understand the problems of the EZ and resistance to reform. New classical macroeconomics' standing in relation to mainstream macroeconomics parallels the standing of neoclassical competitive general equilibrium theory to mainstream microeconomics.

2. Goodhart is perhaps the only establishment economist to have anticipated specific structural problems of the euro, as against generic concerns regarding the euro being a non-optimal currency area. That said Goodhart is a distinguished "grey beard" who was admitted to the circle of central bankers before the ideological boom came down in the 1980s and put an end to pluralism in economic thought.

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From the Maastricht Treaty to the euro crisis – exploring guidelines for reform of the euro system

Jan Priewe

Maastricht with a neoliberal bias

25 years after the Maastricht Treaty of 1992 – which established the architecture of the euro – we can recognize with the wisdom of hindsight that the Treaty was deeply flawed. It was not based on sound theoretical guidelines. It was not the common currency as such that was at fault but the design of the European Monetary Union (EMU), its institutions and policy rules. In retrospect, the main flaws were a neoliberal bias and institutional rigidity combined with minimalism in the institutional setting. The neoliberal bias was based, first, on the belief that inflation control in the EMU depends only on money supply that can be controlled by a truly independent central bank focused on just one goal: price stability

in the euro zone average. Second, growth and employment depend in the long run on supply side factors, mainly technical progress, flexible goods and labour markets, free trade and strong competition on all markets (given the corporatist structure of product markets, more emphasis is placed on labour markets). Absent are problems of aggregate demand so that fiscal policy can be ignored; markets and competition in labour markets can replace nominal exchange rates. Third, there was financial neoliberalism via the propagation of a liberalised single capital market and subsequent deregulation of the financial sector without any banking union. "One market, one currency" was the mantra as if the new currency were just an appendix to the single market.

In this vision, public finance is necessary for public goods but counter-cyclical fiscal policy, that is in essence Keynesian fiscal policy, is unnecessary and potentially detrimental for price stability. A little dose of short-term fiscal policy may be acceptable, contained by the (arbitrary) 3% deficit criterion and the supplementary (also arbitrary) 60% debt/GDP goal for member states, without embracing fiscal policy at the euro area level. Further core beliefs were: having no political union, a slim central EU budget, a ban on debt issuance, and a monetary union (MU) conceived as a euro-club with intergovernmental decision-making, requiring unanimity for key decisions. This implies that the key rules embracing the design of the EMU were carved in stone. In the year 1992, the EU comprised just 12 members which were potential candidates for the EMU; it was not foreseen that by enlargement to 28 members, all of them possible candidates for adopting the euro, the institutional rigidity would be amplified.

The only European sovereign needed in this design is the ECB, not backed by anything like a political sovereign, including a fiscal sovereign. This is more akin to the Gold Standard or a fixed exchange-rate system with supranational money, like using dollars in Panama as legal tender (although Panama has more fiscal space than an EMU member). No fiscal union means no "transfer union", no European treasury, no bail-outs if neighbours fall into financial trouble, no fiscal backstop for the ECB. With regard to monetary policy, the institutional design embraces having no banking union, disregard of inflation variance across members and restrictions upon ECB outright open market operations, even on the secondary markets due to suspected "monetary financing" of governments (in contrast to all other leading central banks regarding the safeguarding of sovereign bonds against default risks). In a single market/single currency economy with many nation states, it is *markets* which should take care of *national* price stability and balance of payment problems – and the belief of EMU architects that markets can do this since they can punish undisciplined member states' policy. Solidarity is – from this angle – disqualified as "moral hazard". The loss of sovereign monetary policy in member states was seen as a blessing, since all too often inflation had been tolerated; and the loss of the exchange rate was regarded as enhancing competition without the cushion of devaluation. Long-standing economic crises, let alone huge financial crises, or persistent high (involuntary) unemployment were beyond the imagination of what can happen in a modern truly neoliberal market economy, endowed with the characteristics sketched above.

This set of ideas, put in practice and engraved in the Treaties, cannot guide a thriving European economy. Such a monetary union is at risk of failure. Some might argue the view described is exaggerated since other initiators of Maastricht, especially from France, but also the then German Chancellor Helmut Kohl, had different visions. Yes, Maastricht was a compromise, but German *ordoliberals* from the Deutsche Bundesbank and the Ministry of Finance most likely predominated (Theo Waigel, Hans Tietmeyer, Helmut Schlesinger, Otmar Issing, Horst Köhler et al.); the Conservative British government led by John Major, successor of Margaret Thatcher since 1990, had to give its consent (eventually with an opt-out clause over adopting the euro).

Unsatisfactory guidance from OCA theories and mainstream economics

How about the economics profession? One old guiding principle for a MU was and for some still is the theory of optimal currency areas (OCA). However, there are different generations with conflicting recommendations. Most critics of the euro project follow the first generation, mainly views from Robert Mundell (1961) and Ronald McKinnon (1963). Here preconditions are factor mobility and trade integration between members, in particular labour mobility, and little exposure to asymmetric shocks hitting only some members. From this angle, the euro area is clearly a non-optimal MU. The argument is reinforced by Peter Kenen (1969) who called for similarity among economies and hinted at the need for fiscal federalism and therefore indirectly a common state.

The second generation of OCA theories, starting with Mundell (1973) and extended by McKinnon (2002) (and others), argued that large MUs might be optimal if some monetary aspects are included. A MU with a hard currency, backed, say by the reputation of the DM, abandons currency mismatches, "original sin" (i.e. issuing debt in foreign currency) and country-specific risk premia; thus, they benefit from lower inflation and lower real interest rates which favour investment, growth and employment. Cross-country financial integration with portfolio diversification may reduce risks from asymmetric shocks.

Most critics of the euro have disregarded OCA II. Yet, both generations of OCA theories do not address the design features of a MU, the role of statehood and the concrete institutional setting, especially in respect of the policy mix of monetary and fiscal policies (except Kenen). OCA generation II is unclear about the potential replacements for sovereign monetary policy and for the nominal exchange rate of members. Issues of financial regulation such as banking union remained completely unheeded. Hence, all OCA concepts are not sufficient advice for policy makers.

However, what can be learned from the variety of OCA theories and debates about them is the following. *Advantages* of a MU, compared to national currencies, are the ones advised by the second generation of OCA theories. They can be augmented if fiscal federalism exists, especially in the case of low labour mobility across borders, and in this respect represent better options to cope with asymmetric shocks. Fiscal policy facilities, centralised or decentralised, are indispensable. *Risks* of a MU pertain to proper replacement mechanisms for national monetary and exchange rate policy,

including the Lender of Last Resort (LLR) functions of the central bank, current account imbalances and divergence of development, especially in the case of dissimilar members and the absence or incompleteness of a common state. Some of the risks were emphasised by the first generation of OCA theories. The extent of risks and hence the net benefits depend very much on the *design of the MU,* and here in particular on the role of fiscal and financial policies and common regulations. It becomes evident that a large and heterogeneous MU without a strong federal state is an ambitious experiment with no successful predecessors.

If policy-makers turn, frustrated by diverse opinions on OCA concepts, to mainstream macroeconomics, represented by the "New Consensus" and backed by and large by neoclassical and New Keynesian economists, they learn that monetary policy is virtually almighty and can steer economies to macro-equilibrium with full employment and low inflation. Fiscal policy plays a minor or even negligible role, unless it turns into an inflationary stance so that fiscal expansion needs to be restricted. In severe recessions, an expansionary fiscal policy may have a role, but only as long as government finances are "sound". Later, the credibility approach came in arguing that under heavy debt and deficits austerity improves credibility and triggers growth ("expansionary fiscal contraction"). All this supported the view that fiscal policy is unnecessary in a MU.

This set of ideas was heavily questioned by other streams of thinking in the economics profession, by Keynesians of different hues and by many empirical analysts. Key insights from their research shows, *inter alia*, the following: investment is much less interest rate elastic than was thought,

in particular in recessions, thus limiting the power of central banks; business cycles are strongly driven by credit cycles due to varying leverage, and modern capitalism is strongly finance-driven – requiring more financial regulation, not less; aggregate demand in a MU can be steered by fiscal policy, especially in recessions – and when targeted on public investment; the weight of the fiscal stance for macro performance becomes stronger in economies with a large public sector (often above 30% of GDP); the credibility approach to fiscal policy is deeply flawed, theoretically and empirically as well, in particular in economies without a national currency and no options for exchange rate adjustments.

A better guide than OCA theories or mainstream economics may be the wisdom of hindsight when we look at the emergence and evolution of the euro crisis. This narrative is very telling and will lead us to proposals for reform. The lessons learnt, in my view, do not concern the euro as a common currency *per se* but the specific design (or architecture) established in the euro zone.

Five lessons from the euro crisis

The euro crisis is considered as meaning the specific problems emanating in the "crisis countries" (Greece, Ireland, Italy, Portugal, Cyprus, Spain – GIIPCS) after the Great Recession 2008-9, starting in 2010 and lingering until now (2017). There is no counterfactual information as to how the global crisis would have hit member countries if they had retained their national currency. The specific nature of the euro crisis came with the stark emergence of sovereign

bond spreads from 2010 with contagion risks, leading to an outright sovereign debt crisis, intertwined with systemic banking crises. The main underlying causes were private sector credit booms, amplified in Greece by a fiscal spending boom. The credit boom was connected with high current account imbalances in the whole euro area, accumulated from a near-balance in 1999 to record intra-EMU imbalances in 2008 and thereafter to record extra-EMU imbalances.

The causes of the euro crisis can be classified within three categories: (a) those resulting directly from the common currency, i.e. the loss of domestic monetary policy and of control of nominal exchange rate changes, (b) design flaws in the Maastricht and subsequent Treaties, leading to design-based policy flaws, and (c) other policy flaws which could have been avoided within the given legal framework. In what follows, I list in the first instance five conspicuous problems; these are then collated within one of the three categories.

Inflation divergence

The starting point for the run-up to the crisis was a positive asymmetric shock in the GIIPCS, benefiting them with lower real interest rates than before the adoption of the euro. However, this triggered above-target inflation, in parallel with below-target inflation in Germany and some other countries, and heavy short-term capital inflows from northern euro members to the GIIPCS. They were amplified by Germany's poor domestic demand growth which induced net capital outflows toward asset price bubbles in GIIPCS and in the US as well.[1]

This way, the low interest rates in the later crisis countries could not fully realise their productive potential.[2] The systemic problem, partly foreseen by the well-known Walters critique[3], was twofold: First, these countries had higher inflation rates (than target inflation) of up to around two percentage points which led, cumulated year by year, to a bloated price level compared to the surplus countries. Nobody cared about it. ECB felt no need to be in charge since average euro zone inflation was satisfactory, nor did national central banks or treasuries responsible for national fiscal policy. The problem was – one size monetary policy fits none if inflation rates diverge. The only policy that could have prevented diverging inflation rates – given the absence of nominal exchange rate realignment – would have been national counter-cyclical fiscal policy (putting aside wage policy coordination in the euro zone). Diverging price levels in the euro zone contributed to diverging price competitiveness, aggravating current account imbalances at the same time. Second, the low real interest rates in GIICPS triggered credit and asset price booms with excessive leverage of banks, aggravated by regulatory arbitrage that attracted financial inflows in Ireland, Spain and elsewhere. Banking regulation was both fragmented and/or disregarded with the mantra of deregulation holding sway at all levels and in many countries. Furthermore, asset price inflation was generally (also in the US) not seen as a policy problem to be addressed. Ignoring both inflation divergence as well as coordination and the strengthening of banking regulation was a double policy failure of euro area institutions, not a failure caused by the introduction of the euro.

ECB's timid and too late policy responses

The ECB responded by purchasing securities from crisis countries (Security Markets Programme, SMP) to contain spreads, but the programme was too timid (limited volume, sterilised) to prevent the infamous sudden stop of financial investors who had purchased sovereign bonds in Southern countries with slightly higher interest rates before the crisis and who had injected so much short-term finance into the bubble economies. In the midst of the crisis the ECB raised interest rates twice (in 2011) fearing inflation, a misguided act under its then President Trichet. Rising spreads signalled contagion and looming risks of state bankruptcy which had been absent in all OECD countries with debt (of central government) accounted for in their own currency since the Second World War. Spreads leapt upwards immediately after the "haircut" for Greece with "Private Sector Involvement" (PSI) on which the Eurogroup decided in early 2012, against the opposition of the ECB which foresaw the ensuing problems (Brunnermeier et al. 2016).

The announcement of the Outright Monetary Transactions (OMT) programme by Mario Draghi, Trichet's successor, came with a verbal promise in 2012 that ECB would do everything within its mandate to preserve the euro: "And believe me, it will be enough." These words allude to the possibly limitless "fire power" of a central bank, in contrast to fiscal interventions. Immediately, spreads fell, but the OMT programme – designed to allow the purchase of sovereign bonds from selected members under certain conditions – was never applied. Draghi's speech prevented a potentially explosive acceleration of the euro crisis. That

OMT has not been applied is likely due to the German Federal Constitutional Court which questioned its compatibility with the *Grundgesetz* and ECB's mandate. The point of contention is the prohibition of monetary financing of states. The response of the European Court of Justice gave only ambivalent support for the ECB. This signalled that the ECB has not sufficient legal backing to act as a full "Lender of Last Resort" (LLR), regarding banks and their main assets, namely sovereign government bonds. The result is that spreads still depend on the mood of financial investors and the rating of rating agencies[4]; rising spreads can swiftly return if risks loom ahead. This weakens the financial systems in crisis-ridden countries and can drain liquidity out of banks and induce capital flight among wealth owners.[5]

Often, it is held that Draghi's words of 2012 were a sufficient replacement for the OMT. This can be questioned because the effects of OMT as well as Mr Draghi's pronouncement are diluted because of linking OMT to the European Stability Mechanism (ESM), founded in the same year. The ESM can provide up to €500bn preferential loans to bail out countries and banks that have lost market access. Accessing the ESM requires that the country has ratified the fiscal compact, accepts the conditionalities imposed and follows them strictly under the continuous evaluation of the "Quadriga" (formerly Troika but since 2015 including ESM representatives). The OMT can only be used if there is a green light from the ESM. Decisions of the ESM require approval from national governments, with quasi-veto rights for Germany and France. In Germany, parliament has to approve. The German Federal Constitutional Court defined in its 2016 decision the restrictive conditions to be met by

ECB if it is not to be considered "monetary financing" of a state (*inter alia*, pre-announced volume of maximum purchases, i.e., not limitless "fire power"). All these conditions render OMT *de facto* inapplicable, quite apart from countries already being deterred from asking the ESM for support. Hence, the ECB's LLR capacity is severely constrained.

Had the ECB started the OMT programme with GIIPCS (or something similar, like the SMP, but with possibly unlimited purchases) without all the restrictions as early as 2010 or 2011, most likely investor panic would have been prevented very soon, spreads reduced or erased, doubts about insolvency repelled, the quality of collateral for refinancing at ECB unimpaired, and the rating by rating agencies a notch or two higher.

The ECB started with full quantitative easing (QE) in 2015, seven years after the Fed, apart from undertaking a small programme for purchase of covered bonds (a kind of corporate bond) in 2009. This belated response contributed to the double-dip recession of 2012-13 (Bibow 2016), along with fiscal tightening. Mention must also be made of the fact that the ECB under Trichet had forced the Irish government to bail-out banks in order to protect the main creditors, French and German banks; this led to a wave of austerity in Ireland. As a member of the "Quadriga", the ECB is heavily involved in imposing austerity on ESM programme countries.

Austerity

After 2008-9, when several European countries, including Germany, had embarked on counter-cyclical fiscal policies,

most others turned to austerity in a broad sense in 2010 with three elements: contractionary fiscal stance, wage cutting via flexibilization of labour markets, "structural reforms" which in most cases include spending constraints. This was an important contributor to rising interest rate spreads in GIICPS. Despite monetary policy at the zero lower bound (being not really expansionary with stagnating broad money and credit growth), the double-dip recession ensued in 2012-13. This recession was overcome in 2014 only because of loosening fiscal policy constraints (disregarding the fiscal rules) and by devaluation of the euro, leading to a current account surplus of 3.7% of the euro zone (2016). The current account imbalance problem remains in different form since the euro zone surplus is carried almost entirely by Germany, the Netherlands and Ireland, while the others hover around zero. Euroland is hereby split into two. The crisis countries, including Finland, taken as a bloc, have not yet reached the GDP-peak of 2008 in 2016, nine lost years later, while the others had recovered already in 2011 but suffered slow growth thereafter. Mountains of unemployment remain in large parts of the euro area. The economic performance of Greece is a show-case for the disastrous results of excessive and counter-productive austerity.

Debt overhang

Lastly, the problems of government insolvency in one country, Greece, remain unresolved in 2017, leaving the country in dire limbo, paralysing the functioning of the banking sector and hence the recovery of fixed investment.

Also the debt overhang, mainly banking debt, in Portugal, Italy and Spain is still unresolved. The bail-in concept of the Eurogroup and the Commission, applied to Cyprus, does not seem to work. Hence, many banks are burdened with bad loans, unable to live, unable to die, on the verge of becoming zombie banks, thereby hampering recovery and always being on the brink of a fresh inflammation of contagion. As a result, the interbank money market is still paralysed since banks distrust each other and hold lots of liquidity at the ECB.

Lack of expansionary fiscal policy options

The European Commission initiated a fiscal stimulus programme in late 2008, called "European Economic Recovery Plan", with around €200bn for all EU countries over two years. This was roughly 0.8% of GDP per year, a bit more in the euro zone countries in which GDP plummeted in 2009 by 4.5%. The Commission allowed governments to break the 3% deficit rule. Despite a rising deficit (from -2.2% in 2008 to -6.3% 2009 in the euro-zone), the fiscal impulse was too small to counter the huge blow of the crisis, and was followed after 2010 by *tightening* fiscal policy. The deficit was reduced to -2.1% in 2015. In 2014, the Commission launched the "European Plan for Strategic Investments" (Juncker-Plan), a three-year investment initiative worth (supposedly) €315bn euro. Much of this is not really additional money and not targeted at the countries with the biggest output gaps or highest unemployment. Obviously, neither the EU nor the euro zone is prepared to

conduct any fiscal expansion despite the fact that the zero-interest monetary policy of the ECB has limited effects on growth, apart from that of devaluing the euro. The explicit or implicit guideline for crisis countries is internal devaluation by cutting wages and other costs to improve the price competitiveness of exports. To some extent this may work, as in Spain, but is a painful and protracted way with only small effects on unemployment since domestic demand for non-tradables is suppressed. There is widespread concern that internal devaluation has contractionary and also possibly deflationary effects if maintained for a longer spell.

So far, I have discussed five crucial policy failures. Two of them are related to fiscal policy. These failures are rooted in the design of the Maastricht Treaty, the Stability and Growth Pact and subsequent rulings (Six Pack 2011, European Fiscal Compact 2012, Two Pack 2013) which are the response to breaking the Maastricht criteria during the financial crisis. The 3% deficit margin was reduced for countries with public debt above 60% of GDP, thereby strengthening fiscal constraints and centralisation of compliance measures at the European Commission. The underlying rationale is that too lax fiscal policy had led or at least contributed to the crisis. It is a programmatic rejection of counter-cyclical fiscal policy.

The other three policy failures (inflation divergence, risks of interest rate spreads and state bankruptcy, debt overhang) are partly driven by causes related to category (a) mentioned above, partly by design flaws (b) in the statute of the ECB as well as in some national constitutions and by the lack of a workable banking union in the case of debt overhang issues. It is clear that a centralised monetary policy cannot bring about similar inflation rates in all member countries alike; nothing

addresses this problem. The loss of national monetary and exchange rate policy is aggravated by the concurrent absence of a centralised fiscal policy and by the constrained member states' fiscal policy space. Such a monetary union may not necessarily collapse, but is doomed to languish in stagnation, continuously on the brink of breakdown and probably not prepared to weather another severe recession or financial crisis with probably even harsher blows to the weaker economies, especially the weaker regions within them.

There is a broad consensus that important reforms of the design of the euro system are necessary, as expressed also by official reform papers from the European Commission (2012 and 2015), the so-called Four and the later Five Presidents Report. What are now the avenues for reform?

Reform options

I will outline four key areas where design reforms are needed, without providing detailed new proposals. Many proposals have already been made, some are on the way of being implemented, many have been rejected by the political authorities, in particular by the hegemonic German government.

Institutional reforms

As mentioned, European institutions and rules for decision-making are trapped in ironclad treaties. Pivotal decisions require unanimity among member states. For the euro zone, all of the relevant institutions are informal[6]: the European

Council for the 19 euro members, the so-called Eurogroup (the ECOFIN Council for the euro countries), the "Quadriga" (including the ECB which has no mandate for general policy issues, and the IMF that is subject to a different jurisdiction). All these informal "entities" take far-reaching decisions. The European Commission is partially involved, the European Parliament only marginally. There is no transparency about the working of these three institutions, not even minutes about their meetings are disclosed. The representatives of the euro member states are only accountable to their government and to their national parliament; even so, they deal with issues of grave importance for other member states. If unanimity is necessary, it is likely that key countries have the status of *primus inter pares* if not a *de facto* superior veto right compared to less important members. Backroom deals, horse-trading and deals with *quid pro quo* arrangements are common. Members are not always treated equally. At times, members in these councils need explicit backing from their national parliament in some countries, in others not. Unanimity rules make decisions difficult or impossible, hence there is built-in inertia. Such rules, based on intergovernmental coordination rather than democratic majority rule, imply permanent grand coalitions of political parties. This is not only in conflict with basic tenets of parliamentary democracy, but cements slow, inefficient decision-making or even avoidance of or delay in taking decisions, with forward-looking decisions driven by national rather than European interests. New modes of decision-making should also include more latitude for discretionary decisions.

Some see the making of new intergovernmental treaties with varying members as a way of bypassing these rigidities,

as happened in the case of the Schengen Agreement, the Fiscal Compact and the ESM. However, these novel treaties are carved in stone again, requiring unanimity of signatory states for amendments. They bring only short-term relief.

Abandoning these institutional rigidities requires quantum leaps. First, the euro area needs special institutions, in contrast to those ruling all EU members. Second, indirect "second degree" democracy – with the European Council acting as a government of 28 (or 27) governments – needs to be reduced, by granting more power to the European Parliament or establishing a Two-Chamber system as well as a euro zone economic government. Thirdly, majority rules should apply to at least some of the key issues, in particular to changing treaties (in the same way as national constitutions can be amended in most countries with a qualified majority). This would be a great leap in achieving a higher degree of European statehood, efficiency and democracy. There can be many small steps in this direction, but at some point, one must leap forward.

ECB as extended Lender of Last Resort or replacement arrangements

Let's assume that the ECB should be able to purchase unconditionally government bonds of all members on secondary markets if the spread reaches a certain threshold, say 200 basis points. Sovereign bonds could be rolled-over at maturity. All sovereign bonds would remain safe, and function as safe assets (risk-free or with a limited risk) in the pyramid of financial assets as in all other OECD countries with debt expressed in

their own currency. Domestic banks often hold big chunks of these bonds, and are at risk when bond prices fall. A full LLR could avoid the doom loop of over-indebted banks and states. Speculators are thereby deterred and bondholders tempted to turn to sudden stops will refrain from panic (unless private securities held by banks lose their value). State bankruptcy will not be possible. Contagion risks are mitigated. In principle, this can be achieved with the OMT programme which does conform with the Treaties even though this is questioned by the German Federal Constitutional Court (as mentioned above). A clarifying amendment in the German constitutional law in this regard would be helpful, given the opinion of the Court that differs from international practice in OECD countries.

The original understanding of the LLR means that banks have unlimited access to liquidity from the central bank but at a higher interest rate. If all banks have a liquidity problem, then all banks should have access. If banks hold government bonds, and these are suddenly exposed to large spreads, all banks together and the state are at risk. What is proposed here is an extended LLR function of the ECB. For all counter-arguments often levelled against the extended LLR (moral hazard, inflationary effects, confusing monetary and fiscal issues, not applicable to member states in the euro zone, etc.), see the forceful rebuttal of De Grauwe (2013). The ESM cannot perform this function as set out here and is an unsatisfactory replacement for the LLR of ECB (apart from its other functions that are required for the support of ailing banks, such as recapitalisation).

If an extended LLR function for the ECB is rejected, a European agency could be founded that issues euro bonds.

There are a number of proposals for euro bonds on the table (Brunnermeier 2016, pp. 111 ff.). The idea is that a considerable fraction of national bonds of all countries should be replaced by such euro bonds. Their issuance would be mutualised on presumably favourable conditions. They can be rolled over at maturity, and the ECB may purchase them, without legal queries, within the framework of ordinary open market policy. This could be a replacement of the LLR role described above but that of LLR is much simpler and safer.

All proposals mentioned here – extended LLR, ESM, euro bonds – involve some degree of direct or indirect mutualisation of national debt. This is unavoidable in a MU; it is the price worth paying for financial stability, benefitting all, like a public good.

Fiscal policy capacity

A fiscal capacity is needed for counter-cyclical policy and for financing public goods provided for the euro zone (or the whole EU). As mentioned, the present rules do not provide a relevant central fiscal capacity, apart from the paltry EU-budget (only 1% of EU GDP), with no capacity for levying taxes and issuing bonds. The European Fiscal Compact and the Stability and Growth Pact prioritise balanced (structural) budgets, allow far too little fiscal leeway in an expansionary direction and impose no commitment to act counter-cyclically. In principle, there are three options for reform:

a. Establishing gradually a large central budget similar to that in federal states with a treasury, by shifting tasks and tax revenues from the national to the supranational level,

accompanied by moving decision-making from national to supranational institutions. The central budget may potentially restrict itself to providing union-wide public goods, or providing transfers and re-distributing income among members. In case debt is issued, counter-cyclical fiscal policy could be applied at the central level.

b. Providing more fiscal space at national level, loosening the 3%/60% convergence criteria and replacing them with a commitment to reach target inflation in all member countries and counter output gaps.

c. Establishing a centralised European financing facility, a European treasury in a nutshell, that issues euro bonds to cover all member state budget deficits and allocates the proceeds proportionally to national budgets.

In both b) and c), budget balances follow a common fiscal rule that should include the "golden rule" for debt-financing of public investment and should, besides this, be oriented toward a fiscal Taylor rule[7] (budget balances depending on the inflation and output gaps). Monetary policy would remain as the main policy for fighting inflation union-wide, but supported at the decentral level. Automatic fiscal stabilisers could be included in a), b) and c). In c), if fiscal deficits and surpluses are set discretionarily without strict caps, the debt/GDP ratio follows endogenously, mainly determined then by the ratio of interest rates and medium-term growth. Sanctions for guiding national fiscal policy in option b) could be cutting access to EU structural funds, reducing the allocation of seigniorage or suspending the LLR function, withdrawing voting rights in the European Council, dismissing the EU commissioner from a given country, or something similar.

Option b) – which I prefer, following Eichengreen/ Wyplosz (2016) and Wren-Lewis (2016) – helps to counter the Walters' critique of the euro system, is adjusted to the specific fiscal needs of heterogeneous members, strengthens national budgetary rights and responsibilities, and avoids potentially large-scale fiscal redistribution among EMU members via a centralised budget as in option a). For option c) a number of proposals exists, for instance from Palley in this volume, Bibow (2013, 2016) and Tabellini (2016, based on several other authors). All three options require a European Treasury which monitors national and central fiscal policies and which should be elected and controlled by the European Parliament and approved by the Council.

Adding to these policy options, current EU budgetary rules should be changed to provide the capacity to levy a European tax, incur debt and issue bonds to a limited extent for EU-wide public investments. The EU budget would be enlarged only moderately, if option b) or c) is followed. Institutional details cannot be elaborated in this article.

Macroeconomic imbalances

Chronic current account imbalances should only be tolerated to a small degree, say +/-3% of GDP or less, especially if they are not caused by differentials in long-term GDP growth. Imbalances within the euro zone members cast deficit countries into internal devaluation which dampens their growth, prompt deflationary tendencies, increase financial vulnerability, lead to economic divergence and to a misfit of the euro exchange rate vis à vis other currencies (one-size-fits-nobody

problem: the external value of the euro may be appropriate for one country group, but induces heavy surpluses in the other, or vice versa). Imbalances are caused by three drivers, which must be reversed for *ex post* correction and avoided *ex ante*: trend towards real over- and undervaluation due to divergent cost dynamics; surplus countries save continuously more than they spend (both public and private spending), vice versa in the case of their deficit counterparts; diverging structural change with regard to modern and diversified sectors with superior international competitiveness in surplus countries and vice versa in deficit countries. In most cases, all three factors play a role.

As for rebalancing current severe imbalances, fiscal policy could be used first. The adjustment burden should be placed asymmetrically primarily on the surplus countries since deficit countries would otherwise fall into prolonged austerity (see Müller and Janssen in this volume), possibly into deflation, while surplus countries should spend more via fiscal expansion; they should shoulder temporarily a somewhat higher than target inflation, embarking therewith on internal revaluation. Second, a European wages policy guideline could be helpful, supporting counter-cyclical fiscal policy in member states. Such a wages guideline would call for nominal increases set according to the country's productivity increase plus target inflation rate, if external balance and target inflation are achieved. If not, again asymmetric adjustments are required, making adjustments in the surplus countries the priority. Governments may influence wage policies via this guideline with an incomes policy for the civil service, a minimum wage policy and legislation to promote centralised wage bargaining at national level. European

monitoring is necessary. Third, industrial and innovation policies in deficit countries should promote structural change and technological competitiveness, especially in semi-industrialised countries with a weak and small tradable sector such as Greece, Portugal or the Baltic states. If these adjustments are not accepted by member states, sanctions similar to those used for fiscal policy non-compliance could be imposed. Ultimately, stronger measures, using for example taxation of exports or imports, could be prescribed. Since correction of imbalances takes time, if painful ruptures are to be avoided, preventive measures must take priority. Since the loss of nominal exchange rate adjustments is a key point of vulnerability for a MU, a strong emphasis on preventive action is a *sine qua non*.

As there is much consensus in the euro zone that a *banking union* with its four parts – single supervision, single resolution, common deposit insurance, plus macro-prudential regulation – is urgently necessary and one of the greatest sins in the euro zone design, I refrain from commenting on them (cp. Schuberth in this volume).

Since the euro zone was started prematurely with so many shortcomings in its design, it will likely take a long time to re-design it. Nevertheless, those points of vulnerability which could bring the euro zone close to economic or political collapse need to be addressed first, with the greatest urgency.

Notes

1. Capital inflows came not only from surplus countries with *net* outflows, but also from other countries with a more balanced current account via *gross* capital outflows (such as France).
2. Although gross fixed capital formation, as a percentage of GDP, rose most conspicuously in Ireland, Spain and Cyprus by 5-6 percentage points 1999-2007, the ratio of fixed investment other than for construction remained almost constant. This was not so in Greece, Portugal and Italy (calculated with data from AMECO database).
3. Alan Walters was economic adviser to Margaret Thatcher, who strongly rejected the EMU by hinting at follow-up problems of divergent real interest rates caused by divergent inflation rates. The British Keynesian Wynne Godley (1992) endorsed Walters' view but pleaded for a political union. Another prominent early Keynesian critique of the euro came from Thirlwall (1998).
4. EMU members need at least one credit rating of "investment grade" for sovereign bonds to qualify as collateral for the ECB. ECB accepts four rating agencies (the three big ones and the Canadian DBRS). If the credit rating is below the required level, countries have to apply to the ESM. For instance, Portugal depends on the satisfactory rating from only one agency, i.e., DBRS.
5. Greece, an extreme example, experienced since the outbreak of the crisis three recapitalisations of banks.
6. This implies that *officially* governments participate in decisions on EMU in the European Council include those which are not members of EMU, such as the UK.
7. The Taylor Rule is a rule for the conduct of monetary policy. The policy interest rate should be selected according to the output and inflation gap and a "natural" (normal) interest rate.

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Advocating new reforms of E(M)U economic governance

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The crisis which started in 2008 looks like it is never going to end. Nearly nine years after the meltdown of the financial system and the violent recession followed by the euro crisis in 2012, recovery has been weak in the Euro Area. This elusive recovery has had dramatic consequences. In 2016, 16.2 million people in the Euro Area were unemployed. This is more than 2.5 million fewer than the high of 19 million in 2013, but it is still far from the 11.7 million unemployed in 2007 before the Great Recession kicked in. Moreover, 8.8 million people were long-term unemployed in 2015 and among them 5.7 million belong to the category "very long-term unemployed" (defined as 24 months or more of unemployment). The number of young people not studying, not working and not in training (NEET) skyrocketed, creating a permanent effect

of the crisis. The situation is especially worrisome in the Southern European countries that have high NEET-rates, reaching 21.4 percent in the case of Italy (Eurostat). The deflation risk is also pervasive and the recent surge in headline inflation should not hide the low level of underlying inflation in the Euro Area. Public finances remain a major concern as some countries are still in the excessive deficit procedure. The debt-to-GDP ratio exceeds 60% for all Euro Area countries but the Baltics, Luxembourg and Slovakia. Most Eurozone members will therefore pursue fiscal consolidation to comply with existing fiscal rules. Despite a reduction in current account deficits in the deficit countries, external imbalances have not been fully reduced since this decrease in deficits partly results from economic slack. It might then revert to rising when those countries recover from the recession. Finally, the global financial crisis emphasized the need to reinforce financial stability to prevent future crises.

Undoubtedly, a lot of institutional and economic reforms have been implemented in the EU since the onset of the financial and sovereign debt crises. But, broadly speaking, these reforms either did not address the Euro Area's structural flaws or, if they did, in a way that fuelled other imbalances and fed centrifugal forces. Against this background, we advocate a few policy reforms in fiscal and macroeconomic imbalance management in order to regain EU endorsement by its citizens[1]. Under a consistent agenda which emphasizes short-run policy objectives without neglecting long-run ones, we believe the EU's full recovery and high potential growth could be within reach.

1. The narrative of the crisis

The policy choices explain to a large extent the elusive recovery observed mainly in the Euro Area. If the initial impact of the Great Recession on GDP and unemployment was similar in the Eurozone compared to other economies, the recovery that followed was disappointing. The divergence of outcomes reflects the divergence of macroeconomic policies. On the one hand, the Euro Area managed to stabilize its public debt and accumulated external surpluses more successfully. On the other hand, the United States and the United Kingdom have been more pragmatic about public deficits and debt and chose to backload their fiscal adjustment. They have thus stabilized demand earlier and better and have attracted capital flows from surplus countries. In so doing, they recovered faster from the financial meltdown. Of course, it is important to point out that neither the US nor the UK had to suffer from the euro debt crisis because their central banks, unconstrained by the Euro Area's institutional complexities, took up their role as lender of last resort for governments sooner and triggered unconventional policies more effectively. In this context, productive public and private investment is picking up in the US and the UK, creating the basis for future prosperity.

To legitimize the EU's responses to the crisis, which included the adoption of a comprehensive institutional reform over a relatively short time span, there had to be a common view about the causes of the crisis. This view shaped the policies which were then implemented.

The usual causes explaining the Eurozone crisis are: too many debts (public and private) were borrowed abroad

(see e.g. CEPR, 2015). Contrary to what Ingram (1973) may have expected, the Euro Area crisis shows that countries which form a monetary union may suffer a severe crisis when financial flows suddenly stop. This is all the more so when the massive capital flows from core countries (notably Germany, France and the Netherlands) to the periphery (Spain, Ireland, Greece and Portugal) are invested in non-tradeable sectors (construction, consumer credit or government consumption) that drive prices and wages up and harm the competitiveness of the tradeable sector, reinforcing the current account deficits of peripheral countries and increasing their dependence on net capital inflows. The fact that those imbalances emerged in an incomplete single currency (no banking union, no crisis management framework, no lender of last resort) amplified the crisis.

To understand how different narratives of the crisis appeared, it is worth recalling the three main determinants of current account imbalances. As they rely alternatively on public or private variables, they made it possible to either focus on growing public debts or on growing private debts.

First, current account deficits reflect an excess of spending over income and more precisely an excess of investment over savings. To restore equilibrium, it is vital to reduce investment or to increase savings. Government consumption may be a major driver of domestic demand, notably in countries that failed to meet the Stability and Growth Pact (SGP) targets (Greece and Portugal for deficits or Italy for public debt). Consequently, ensuring sound public finances is also a way to correct the twin (public and trade balance) deficits.

A second point of view focuses on capital flows into fast-moving economies with high returns. From this point of view

a current account deficit is not necessarily the symptom of disequilibrium. In the case of a country with a strong growth potential, which is catching up vis-à-vis more advanced countries, an external deficit can correspond to a healthy situation: external financing helps the catch-up toward the technological frontier. Since future growth will provide the basis for reimbursing the liabilities, the deficit is transitory and there is no reason to worry. This is the type of mainstream reasoning which emerged before the financial crisis and helped explain the deficits of southern countries (Blanchard and Giavazzi, 2002). However, the undergoing process in the Euro Area did not fit into this optimistic scenario and rather showed an unsustainable divergence dynamics. Private capital inflows in southern countries were not directed towards sectors with strong productivity gains, but fuelled housing bubbles and financed low-innovative sectors and consumption credit. Hence, this explanation of current account deficits points out the negative consequences of mispricing in the assets markets and suggests that prudential policies and the monitoring of prices and capital flows is key to preventing future crises.

Finally, current account deficits may also emerge as the consequence of poor external competitiveness. Competitiveness divergence may be amplified by foreign capital inflows when they are concentrated in low productivity non-tradeable sectors that generate inflationary pressures. Those pressures can be reinforced by rigidities in the labour and product markets. From this point of view, monitoring the evolution of wages and prices and ensuring more flexible markets are required.

These three explanations hinge alternatively on public or private variables and paved the way for two rival narratives of the crisis.

The first focused on the excess of (public) demand as the main cause of current account deficits in peripheral countries. Indeed, the kick-off of the crisis looked very much like a public debt crisis. In October 2009, the freshly elected Greek government admitted that public deficits and inherited public debt were in reality much bigger than previously thought. If at the beginning there was the sentiment that this was exclusively a Greek problem, financial markets lost confidence in the health of public finances in an increasing number of countries. This resulted in the dramatic rise of sovereign bond spreads for some countries, after almost a decade of convergence. To restore confidence, it was decided to strengthen the European fiscal governance. In 2011, the "Six Pack" sought to improve compliance with the SGP framework and reinforced the corrective arm of fiscal governance. In particular, it limited the Council's power to refuse the sanctions recommended by the Commission against countries missing their commitments. More importantly, in 2013 the introduction of the Fiscal Compact hardened the target of structural balance that Euro Area countries are expected to achieve. From now on, a budget is judged "balanced" if the structural deficit is lower than 0.5 point of potential GDP. Moreover, the "Two Pack" reinforced the transparency and coordination of fiscal policy among member states.

If the Greek and the Portuguese cases are relatively well explained by this narrative, this is not true for the other countries. In particular, this narrative is at odds with the rise of sovereign spreads in Spain and Ireland, countries that were among the best performers in terms of respecting the SGP targets before the crisis. A second narrative emerged,

pointing up the fact that the roots of the crisis lie in the emergence of unsustainable private debt and divergent price-competitiveness. In this narrative, it was necessary to monitor a broader set of macroeconomic indicators. In 2011, the Macroeconomic Imbalances Procedure (MIP) was introduced as part of the surveillance framework that aims to identify, prevent and correct such imbalances. The MIP consists essentially of monitoring a set of 11 indicators covering the major sources of imbalances identified above. This set of indicators is the MIP's scoreboard, whose aim is to create an early-warning system on problematic macroeconomic imbalances.

The institutional framework of macroeconomic governance changed dramatically during the crisis. Reform was broad and included elements of the three explanations for the build-up of current account imbalances. However, it suffered a bias towards fiscal adjustment even if private sector developments were now being monitored by the MIP. This bias can be explained in two ways. First, as the economic situation worsened, the links between banking risks and sovereign bonds risk appeared and the spreads on interest rates reached unsustainable levels in many countries (including Spain, Italy, Ireland, Portugal, Cyprus and Greece). The crisis progressively transformed itself into a full-scale public debt crisis, validating the self-fulfilling expectation of investors demanding clear actions to restore credibility concerning the sustainability of public debt. Restoring credibility and eliminating debtors' risk of moral hazard became the top priority for policy makers. Second, the two procedures have not the same binding power. On the one hand, the rules of the Excessive Deficit Procedure of

the SGP are more clearly specified and set targets for actions taken by Member States themselves. On the other hand, the MIP is less clear, less enforcing and it sets targets for indicators not directly controlled by national governments, *e.g.* the rise in real estate prices. In this context, member states essentially try to stick to the (little or non-existent) fiscal space left by fiscal governance and neglect the targets set by the MIP, with no clear enforcement procedure.

2. Internal inconsistencies in the European economic governance

Since the global financial crisis erupted, Euro Area member states and institutions have not been passive. The economic strategy has relied on fiscal consolidation, conservative structural reforms[2] and an expansionary monetary policy. However, the economic policies implemented so far have manifestly failed to deliver on promises. Not only did the European Commission and Euro Area member states underestimate the cost of fiscal consolidation but they have also failed to discern the inconsistency of this strategy and to recognize the trade-offs inherent in the pursuit of different objectives.

First, achieving fiscal discipline (3% public deficit-to-GDP ratio in the short-term and 60% public debt-to-GDP ratio in the medium-term) has entailed significant output losses (iAGS 2013, Rannenberg et al., 2015), in line with the consensus stressing that fiscal multipliers are high in times of crisis (see Creel et al., 2011). Hence, the fiscal consolidation implemented since 2010 has decreased demand, contributing to reduce current account deficits in the short term, but at

the expense of the unemployment objective. Fiscal consolidation may thus also reduce long-term growth as it goes along with cuts in public investment and a decline in the skills of the long-term unemployed. Furthermore, by feeding the deflation risk, fiscal consolidation has complicated the task of the ECB regarding its ability to meet the inflation target. As illustrated by iAGS report 2013, there is a trade-off between the growth objective and the fiscal sustainability objective, which is a long-term goal. The political choice that has been made has privileged the long-term public finance objective at the expense of growth and has proven counter-productive: debt-to-GDP ratios have risen.

Second, the claim was that conservative structural reforms would reduce the unemployment rate and correct current account imbalances. However, the positive effects of structural reforms have been overestimated and it has been overlooked that these effects, when positive, take time to be delivered. Eggertson and Krugman (2012) have also pointed to the risk of counterproductive effects with structural reforms. In a zero-lower-bound (ZLB) context, the decrease in the inflation rate increases the real interest rate and triggers a debt-deflation spiral. Consequently, achieving the reduction of current account imbalances and reducing the long-term unemployment rate may be feasible through structural reforms but it may be at the expense of short-term output growth and of debt reduction. The deleveraging process is then made longer and harsher (as illustrated in iAGS 2016 and 2017).

In this context, the main stimulus for the Euro Area economy rests with the ECB. However, standard monetary policy is constrained by the ZLB, leading central banks to

implement unconventional monetary policies. The ECB has engaged in quantitative easing (QE) operations since 2015 with the aim of bringing inflation in the Euro Area back to the 2% target. Unconventional monetary policy is also expected to support demand. Moreover, through its impact on sovereign yields, QE could reduce the need for fiscal consolidation. It therefore appears that, in contrast with fiscal and structural policies, an expansionary monetary policy may have positive spillovers on the other policy objectives. Yet, Borio and Zabai (2016) suggest that unconventional monetary policy could have decreasing returns and threaten financial stability by fuelling asset price bubbles. This illustrates an additional trade-off between price stability and financial stability. If the ECB is leaning against the wind to achieve financial stability, hence implementing a restrictive monetary policy to dampen financial bubbles, it will underperform its inflation target and recovery will be slowed down.

The multiplicity of EU objectives over different time horizons – price stability and unemployment in the short run; public debt, financial stability and price competitiveness in the long run – requires one to solve the trade-offs. As the Tinbergen principle states, a limited number of policy tools can only achieve the same number of objectives. Consequently, priorities need to be defined and backed by political support. Until then, most political decisions have emphasized the long run over the short run. When these decisions have failed, the urgent task is certainly to enact a comprehensive package to meet all the European objectives consistently. It involves changing priorities – with an emphasis on curing the damage

caused by the divergence observed during the Euro's first decade and the crisis itself – and enhancing democratic enforcement to make the new rules more legitimate and therefore credible while proving convincing that long run goals will not be overlooked.

3. Solutions

a. Rebuilding confidence

The fiscal policies implemented since 2011 illustrate the EU's institutional weaknesses. By co-ordinating on the basis of rigid rules – like the 3% deficit rule – states are forced into untenable policies that do not produce the promised results, leading European citizens to distrust European institutions.

Monetary policy is facing similar difficulties. The ECB has had to pursue a bold expansionary policy that exposes it more to banking risks and to the risk of default by Euro Area governments. This situation gives rise to a legal challenge concerning the conformity of its actions with respect to its mandate. Such challenges are an obstacle for future decisions.

Lastly, the creation of rescue institutions for the member states facing a liquidity or solvency crisis – in particular, the "troika" of Commission, ECB and IMF – was accompanied by a strengthening of the Union's intergovernmental dimension. However, these rescue institutions suffer from an absence of democratic legitimacy. In fact, they gave greater weight in the decision-making process to the big Euro Area member states and called into question the sovereignty of the smaller countries (*e.g.* Greece).

Crisis countries have made huge efforts to respect their commitments towards the Euro Area. They did not default on their public debt (Greece only restructured part of its debt after the 2010 haircut) and have chosen to remain in the EMU. For a lasting commitment towards the Euro Area in these countries, the EU must reinforce the legitimacy and clarify the responsibilities of the European institutions. This is the only way to ensure effective co-ordination and escape from the trap of short-term views on the stability of public finances, to allow full exercise of monetary sovereignty while limiting implicit or explicit transfers between states. This calls for strengthening the democratic functioning of the Union either through a strengthened European Parliament or by the creation of a new (second) chamber.

b. A democratic re-foundation of Europe

As Chopin (2016, p. 3) put it: "Democracy is basically founded on three fundamental requirements: the democratic definition of political goals; the democratic selection of accountable leaders before the citizens; the exercise of democratic control over the decisions taken to assess whether goals have been achieved or not. With this in view the democratic political system supposes that there are at least two criteria: that of competition and possibility of political change". The current functioning of EU institutions seems far from reaching all these prerequisites.

The Five Presidents' Report of June 2015 has put on the table the question of reforming how European integration functions. The democratic dimension should play a key role

but the debate is now at a standstill. Yet the double question of the level of the exercise of sovereignty, in particular on the budgetary and monetary sides, and the legitimacy of the institutions in charge of exercising this sovereignty arises.

If pragmatism is justified when circumstances reveal the incompleteness of institutions, it is also understandable that European integration is struggling to gain its legitimacy through outcomes (output-oriented legitimacy, in the words of Scharpf, 2003), and that intrinsic legitimacy (input-oriented legitimacy) becomes a necessary answer.

Rethinking the EU institutional architecture to put in place rigorous democratic processes constitutes a considerable task. In the current context, this question cannot be answered by simplistic proposals. In particular, a radical federal leap is unrealistic politically, and its pursuit could strengthen doubts about the European project.

Giving more scope to representative democracy in defining monetary policy issues or within the rescue institutions of member states is a relevant one. The idea of a Euro Area parliament has been justified until now by the dissonance that the British provoked in the European Parliament on issues specific to the Euro Area. Brexit partially overcomes this obstacle, but the delay in its implementation increases the risks of postponing any democratic legitimacy of monetary policy, whose time horizon is much shorter. The ECB's accountability is more of an exercise in communication currently than a formal open discussion about its monetary strategy. It could well be improved without challenging its independence.

Strengthening the EU budget is another avenue. Building automatic stabilization mechanisms such as the proposals

for a European unemployment insurance scheme or a common Euro Area fiscal capacity could help to cope with symmetric and asymmetric shocks. In both cases, it will limit the necessary reliance on the ECB. Ensuring that future investments in infrastructure, education or the social sector are no longer pro-cyclical is also promising.

c. Golden Fiscal Rule

In contrast with current reforms of EU economic governance, we advocate an approach that, while acknowledging the limits of monetary policy, fully exploits the supportive potential of fiscal policy and of correcting imbalances through a cooperative strategy. This approach is also complementary to the possible adoption of a Euro Area fiscal capacity in two ways. First it pertains to both the short- and the long-run fiscal management of the Euro Area. Second, it complements fiscal management with progressive structural reforms.

Domestic fiscal policies are fettered and often passive, except at the margin under relatively bad economic conditions, because of EU rules and national "debt brakes" introduced as part of the fiscal compact. Moreover, the method used by the Commission to estimate the output gap and then the cyclical part of the deficit leads to an overly pro-cyclical fiscal policy (Péléraux, 2014). The implementation of austerity policies during downturns is self-defeating, and for a large part this explains the double dip recession and the sluggish recovery experienced by the Euro Area since 2011. Fiscal consolidation should instead be avoided in times of crisis and be back-loaded after the recovery. Additionally,

public investment has suffered disproportionately under austerity policies, in the absence of special SGP provisions supporting it. It is now at historically low levels in the Euro Area, and the stock of public capital even decreased in 2015. This situation endangers long-term growth potential, given the complementarity between private capital, labour and public infrastructures.

A major reform of the SGP therefore needs to be implemented with the adoption of smarter rules that support public investment and increase member states' budgetary flexibility so as to improve counter-cyclicality, while at the same time ensuring fiscal sustainability and compatibility with the overall EU fiscal and economic policy framework.

A promising reform path is to implement the "Golden Rule" of public finances within the SGP. The Golden Rule is a traditional public finance concept that consists in deducting net public investment from both the headline and structural deficits that are used to assess fiscal compliance. The rationale is that increases in public infrastructures will benefit future generations, and that it makes sense to finance them with debt; conversely, financing these infrastructures with current taxes would probably lead to their under-provisioning. We claim that rebuilding the stock of public assets would be in line with the SGP in that it would help achieve the long-term sustainability of public debts and pension systems.

Of course, the definition of what is public investment should not rely on a narrow accounting concept, but should encompass those projects that provide tangible economic pay-offs, through their complementarities with private capital and labour. Only under this condition will the rule ensure long-term fiscal sustainability. The Golden Rule

would also augment the counter-cyclicality of fiscal policy, by giving back some discretionary power to governments, which will then be allowed to increase public investment projects during bad times. But to really remove the pro-cyclicality of the rule needs a further reform of the procedure implemented by the European Commission for computing the cyclical component of deficits: a method drawing on the medium-term potential growth rate (as in Claeys et al., 2016) would represent a significant improvement.

The launch of the Juncker investment plan is an acknowledgement by European authorities of the public investment deficit. But this plan is far from being a satisfactory answer to the problem. First, it is only temporary in nature, and therefore does not solve the structural deficiency of current fiscal rules. Second, even though its impact is broadly positive, the plan is too small to provide a significant boost to short-term aggregate demand and to long-term growth potential.

Overall, the rethinking of the mix between monetary and fiscal policies is critical for the future of the Euro Area. But it will not be enough to tackle all the challenges faced by the Eurozone.

d. A Golden Rule for wages and current account balance

Indeed, a careful analysis of the sovereign debt crisis has revealed that public debts were the symptom of broader macroeconomic disequilibria and, in particular, of current account imbalances.

Where do we stand today? Faster demand growth, which is needed to bring unemployment down in Southern coun-

tries, risks widening current account deficits once more; in other words, structural current accounts – i.e. current accounts corrected for their cyclical component – are still in deficit in many Southern countries. Symmetrically, Northern countries, and especially Germany, are running huge current account surpluses that could lead to a Euro appreciation, with negative consequences for the competitiveness of all member countries.

If we want to avoid a new crisis of the monetary union – and such a crisis could threaten its very survival – we therefore need a strategy to achieve re-convergence within the Euro Area. And it is critical that this effort is not borne unilaterally by overvalued countries, but is instead borne as symmetrically as possible.

Apart from growth differentials, current account disequilibria result from both price and non-price competitiveness differentials. The re-convergence of the Euro Area should therefore rely on two pillars: a nominal one – via a golden wage rule – and a structural one.

It is well established that current account imbalances are at least partly explained by the divergence of unit labour costs across the continent. Countries where nominal wages have increased faster (relatively to productivity) tend to be those whose current accounts have turned the most into deficit during the pre-crisis period.

Limiting such imbalances within the Euro Area requires a wage rule that serves as a coordination device. More precisely, the golden wage rule implies that nominal wages increase at the rate of domestic productivity augmented by the ECB inflation target of 2%. In the short run the rule should be adjusted to correct for existing nominal imbal-

ances, *i.e.* with wages increasing faster than the rule in the North and more slowly in the South. Note that this scheme is not incompatible with real wage increases, even in Southern countries: since the rule applies to nominal wages, purchasing power can increase either if prices are sluggish or if there are productivity gains.

Tools for the implementation of this coordinated wage policy include: generalization of wage floors and cross-border coordination of any increases in them, some degree of domestic recentralization of wage negotiations, and more collective agreements. Other tools relating to changes in indirect wage costs could also be mobilized.

In parallel, in order to deal with non-price competitiveness issues, policies centered on the convergence of productive capacities and standards of living must also be implemented; in the South, this includes structural investment in export capacities to raise productivity, improve non-cost competitiveness and promote alternative energy production allowing full exploitation of comparative advantages in energy.

Finally, the MIP should be made symmetrical and completed by an analysis highlighting the link between different imbalances and the policy tradeoffs. So far, the adjustment has remained asymmetric, burdening mainly deficit countries. The MIP should be made more symmetric so as to encourage reflationary policies in countries with sluggish unit labour cost dynamics and high current account surpluses. According to the adjusted golden wage rule, a minimum value below but close to 2 % should be introduced for nominal unit labour cost growth. Moreover, the same absolute value should be used for upper and lower thresholds for the current account.

More fundamentally, the MIP scoreboard hides the fact that some imbalances are linked – for example that surpluses in some countries have the same root cause as deficits in others – and that tradeoffs exist between policy objectives. Reducing domestic current account imbalances makes it more difficult for deficit countries to achieve debt stabilization and full employment, because of the deflationary effect and the subsequent rise of the real interest rate. Moreover, correcting the Euro Area's external imbalance – i.e. its high current account surplus – through a Euro appreciation would increase the internal divergence of the zone. Procedurally, the MIP should therefore be expanded with a broader and more systemic economic analysis. Substantively, the right policy to mitigate such tradeoffs is a full utilization of fiscal space in all countries combined with an increase in inflation in surplus countries.

4. Conclusion

Most of the reforms of EU economic governance since the global financial crisis have consisted of either strengthening fiscal rules (like the Fiscal Compact) despite non-compliance with former rules, or building a MIP scoreboard without binding commitments. These reforms have been unsuccessful in triggering a sharp EU recovery. Consequently, they have certainly fuelled discontent with both Euro and EU. It is also striking that other reforms of economic governance have consisted of delegating decisions to non-elected boards (like the fiscal boards and national productivity boards recommended by the Council on September 20 2016), supposedly

representing independent expertise in economic and social matters. The response to people's discontent has been technocratic. In contrast, we believe it is time for the EU to opt for a more progressive and a more democratic management of the Euro: with a common fiscal capacity, national Golden Rules on public finances and wages as well as investments in export capacities, the Euro Area may well recover faster and be better able to cope with key issues for its citizens such as climate change and social, economic and financial shocks.

Notes

1. In this contribution, we stick to the Treaty of the EU and claim that the Euro is part of EU's *acquis communautaire* (except for Denmark and the UK which have an opt-out clause). Consequently, we argue in favour of reforms for the EU which are mainly reforms for the Euro Area.
2. The European banking union can also be included in the set of structural reforms which is devoted to improve financial surveillance in the Euro Area and then reinforce financial stability.

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There Is an Alternative: The Flexible European Currency Community

Fritz W. Scharpf

1. Background

The following text is part of a longer article which, in its preceding sections, is trying to make several connected points (Scharpf 2016):

The Eurozone includes structurally different "Northern" and "Southern" political economies that had performed as hard-currency and soft-currency economies under the previous regime of flexible exchange rates. Northern economies with relatively large exposed sectors had relied on export-led growth models and their coordinated industrial relations systems were capable of generating wage restraint under the leadership of export-sector industrial unions. By contrast, Southern economies with large sheltered sectors had depended on domestic demand-led growth, and their

industrial relations were characterized by union competition and persistent wage dynamics. As a result, inflation was generally lower in the North than in the South, and as long as these differences were compensated by the revaluation and devaluation of exchange rates, both types of political economies had been equally viable in pre-1999 Western Europe.

These structural differences were not acknowledged, let alone dealt with, by the original regime of the Monetary Union. Since they nevertheless persisted after entry, economic trajectories diverged widely after 1999. Low-inflation Northern economies were handicapped by average-oriented ECB monetary policies and high real interest rates, whereas Southern economies were boosted by the fall in interest rates and the rise of credit-financed domestic demand. Until the credit squeeze of the global financial crisis of 2008-09, rising current account deficits in the South were easily sustained by capital inflows from Northern surpluses. But when these stopped, Southern banks were collapsing and the states that came to their rescue were soon faced with challenges to their liquidity and ultimately solvency – which were treated as a Euro crisis requiring institutional changes beyond the minimalist regime established by the Maastricht Treaty and the Stability and Growth Pact.

The new Euro Regime, defined by the European Stability Mechanism, the Excessive Deficit Procedure, the Excessive Imbalances Procedure and the Fiscal Compact, has greatly extended and intensified centralized controls over the fiscal, economic, labor market and social policy choices of EMU member states. As structural differences are ultimately perceived as the root causes of the Euro crisis and of EMU's persistent vulnerability, the regime's acknowledged purpose

is to achieve the structural convergence of Eurozone economies. And since the Euro crisis struck at economies with large current account deficits, it appeared plausible to define a regime that will enforce a structural transformation towards the model of export-oriented Northern political economies. For Ireland with its large export sector, a Euro regime imposing fiscal austerity and wage repression does seem to facilitate export-led economic recovery. For Southern economies, however, the main (and intended) effect of the present regime is to reduce domestic demand to such an extent that not only demand for imports but domestic economic activity and, ultimately, the size of the large domestic sector are drastically reduced. Once that is achieved, the export sector will grow in relative size and political influence, and export-sector unions may come to dominate wage-setting processes. In other words, Southern political economies will converge on the Northern model, the membership of the Eurozone will be structurally coherent and internationally competitive, and the Monetary Union will finally be safe. Or so it is hoped.

For Southern political economies, however, enforced structural conversion has been and still is extremely painful – with massive job losses, excessive youth unemployment, rising poverty – and a legacy of business failures that has reduced the capacity for domestic growth. Even if exports are picking up eight years after the onset of the crisis, the road to export-led recovery of the economy at large continues to be at best arduous, uncertain and very long. And though all Southern governments have treated the Euro regime as being "without alternative", the suffering it imposes on their societies has been immense, and its political impact so negative that none of the regime's loyal supporters has yet

been able to win re-election. In other words, even though the present Euro regime might succeed as a huge economic gamble, it may yet collapse if the failure of its even more risky political gamble triggers the chaotic exit of one or more EMU member states.

Amid rising criticism of its operation and consequences the present Euro regime is generating ever more proposals for its modification. Most of these suggest either a strengthening of centralized capacities to enforce present rules, or a softening of these rules and some sort of financial support to ease the structural transformation of Southern political economies. In terms of the dual gamble, however, both appear counterproductive. More powerful and rigid enforcement would greatly increase the risks of political collapse. And softer rules and transfers are likely to prevent structural transformation and may turn the South into a permanently subsidized European "Mezzogiorno".

Other critics are asking for a more "symmetric" regime that would also treat Northern (and in particular, German) current account surpluses as a major problem. Before EMU, the DM had appreciated when German exports had exceeded imports – and rising imports had then prevented the rise of persistent high trade surpluses. In the Monetary Union, however, the exchange-rate corrective was disabled, and since 1999 German imports have indeed been persistently lower than exports. The effects of the German surplus for the stability of the EMU or for the recovery of Southern economies are in dispute. But even if they should be considered a major problem, on closer examination most suggestions for correcting this imbalance turn out to be ineffective or unfeasible; and the one that might work

– lower VAT (Value Added Tax) rates on imports – is not even considered in academic and political discussion.

To summarize: The paper argues that the Monetary Union is ill designed for dealing with the basic structural differences among Northern and Southern political economies, and that the present Euro regime's attempt to enforce structural convergence may perhaps succeed in economic terms at enormous social costs, but will remain extremely vulnerable to political protests, rebellion and anti-European populist governments. In the absence of good solutions within present constraints, therefore, the paper concludes by suggesting that the Monetary Union itself should be transformed into a more flexible Currency Community that is able to accommodate Northern and Southern political economies at the same time.

2. A Non-catastrophic Alternative to EMU: The European Currency Community

At present, there are two plausible fears which may explain not only the defense of the EMU by its Northern beneficiaries but also the fundamental loyalty of Southern governments even in the face of deep political dissatisfaction with the economic and social sacrifices imposed by the present regime. The first is the belief that exits would not only be catastrophic for the country in question but might also destroy the Monetary Union itself. But though the consequences of individual exits need serious attention, there is surely no need to abolish the common currency for those Northern and Eastern political economies whose

interests and political preferences are well-served by it, or for member states that are politically committed to continue on a course of structural transformation under external supervision (Ferrera 2016). The second concern is the fear of the economic and political isolation of countries that might otherwise be better off outside of the EMU. It is these fears which the following discussion primarily seeks to address.

Under present conditions, an individual exit from the common currency is indeed not an economically and politically viable option. Though its designers did not know how to make EMU work, they were devilishly clever in making it nearly irreversible. Even though in retrospect the move from the flexible European Monetary System of 1979 (EMS) to the EMU may be seen as a dreadful mistake, its reversal is almost universally ruled out by the anticipation of horrendous transition costs and irresolvable uncertainties (Tsoukalis 2016). Indeed, under the present rules, exit may happen as a disaster, but it is not a policy option that could be chosen by responsible governments as a lesser evil, no matter how devastating the Euro regime's impact is on its country's economy or society.

But these conditions could be changed.

In addition to creating a formal right to leave the EMU without having to leave the EU, the feasibility of orderly exit presupposes at least three bodies of rules that would deal with state insolvency, with exit procedures, and with the subsequent relations between exiting states and the EMU. None of these rules is likely to be well-designed under the pressure of an acute crisis. Hence they ought to be discussed and adopted in relatively calm times as precautionary amendments or additions to the general rules governing the Eurozone.

2.1 Rules for state insolvency and an "amicable divorce"

With regard to the first requirement, discussions about rules for state insolvency have been under way for some time at the international level (International Law Association 2010), and it should be possible to adapt these to the restructuring of excessive public sector debt under the conditions of the Eurozone. A more difficult challenge will be the second requirement of procedures and rules facilitating the orderly exit of a member state from the EMU. To minimize repercussions in global capital markets, it would be highly desirable to avoid the uncertainties of controversial and long drawn-out "Brexit-type" bargaining. It might thus be helpful to construct a small set of pre-defined "exit models" with well-balanced rules for different types of problem constellations. They all would need to include procedures for the transition to a national (or parallel) currency, for the treatment of public and private debts defined in Euros, and for financial, legal, and procedural support during the transition period. While I lack the expertise to suggest specific solutions, I am encouraged to see that reputed and knowledgeable economists of very different theoretical and political persuasions appear to be quite sanguine about the availability and effectiveness of practicable options that would reduce the transition costs of a country's exit from the EMU through a cooperatively managed "amicable divorce" (Stiglitz 2016, ch. 10; Sinn 2014; Sinn 2015, 480–492; 2016, 306–309).[1]

2.2 Learning from the faults of the EMS

Even more important may be the third requirement of an economically and politically viable regime governing the future relations between exiting economies and the remaining EMU (rEMU). It would have to be clear (which at present it is not) that leaving the EMU does not conflict with continuing membership of the European Union. Even then, however, the prospect is bound to provoke disturbing concerns about the post-exit fate of economies that will continue to depend on integration in the Single Market: They might suddenly have to cope on their own with turbulent global capital markets and with speculative exchange-rate fluctuations that could wreak havoc on the viability of economically interdependent national industries and that might also trigger vicious price/wage devaluation spirals that could overwhelm all national efforts at stabilization. With regard to these fears, however, promising solutions can be derived from a re-examination of the achievements and deficiencies of the monetary regime that had preceded the EMU.

Before the post-unification crisis of 1992, the EMS regime of pegged but adjustable exchange rates had succeeded in achieving three purposes. It had helped reduce average inflation rates in Europe by obliging member states to use monetary and fiscal policies in order to keep their currencies within 75 percent of the exchange-rate bandwidth (2.25 percent above and below the agreed rate). At the same time, its Exchange Rate Mechanism (ERM I) had protected member currencies against short-term imbalances and speculative attacks by (symmetrically!) obliging

central banks to intervene in currency markets in order to maintain the upper and the lower limits of their respective exchange-rate corridors. And finally, it had prevented the rise of persistent trade imbalances by allowing for agreed-upon currency realignments (Artis and Taylor 1993).

After an initial period of frequent adjustment, the EMS worked reasonably well, not only in dampening currency fluctuations and inflation rates but also in achieving a pattern of nominal exchange rates that reflected economic fundamentals and avoided the dynamic divergence of real effective exchange rates and the emergence of persistent external imbalances. The regime was institutionally vulnerable, however, because it lacked a central bank that was committed to the common interest. As exchange rates were defined pairwise between all national currencies, the Bundesbank (in charge of the largest and hardest currency) came to play a dominant role in all adjustments. Moreover, it had been allowed to insist – in the famous "Emminger letter" (Tietmeyer 2005, 79–80) – that it would not have to engage in monetary policies and currency interventions that might conflict with its basic commitment to price stability in Germany. As a result, the symmetry of interventions was incomplete, and currency realignments were more frequent than they otherwise would have been.

These had to be adopted through difficult and often highly confrontational intergovernmental negotiations (Marsh 2009; Höpner and Spielau 2015) in which Germany was typically forced to accept greater DM revaluations than was good for its domestic growth. After 1987, however, revaluations were ruled out in the quest for even greater exchange-rate stability. When the Bundesbank then chose to

brutally clamp down on the German post-unification boom, it triggered major crises in other member states which in fact destroyed the EMS (Marsh 2009).

The critical design fault that destroyed the ERM 1 has been corrected in its successor regime, the ERM II. It was created on January 1, 1999, for European states that would not immediately join the Monetary Union. Although all of its one-time members, except for Denmark, have now entered the EMU, its institutional framework still exists and remains available for new accessions. It differs from the ERM I in two crucial respects: the ECB retains its role as the central bank for the system as a whole, and the "central exchange rate" of a member currency is defined in relation to the Euro, rather than in a network of bilateral rates among all currencies. As a consequence, market interventions to stabilize the exchange rate of a member state are also negotiated between its national central bank and the ECB, rather than among all national banks.

Under ERM II rules, currencies are presently allowed to fluctuate up to 15 percent above and below their agreed-upon "central exchange rate." This broad bandwidth, which was introduced after the EMS crisis of 1992, may be narrowed by agreement so as to circumscribe the politically desired action space of national macroeconomic management. Hence, if the central exchange rate is initially set to correspond to the underlying economic fundamentals, stabilizing interventions in international currency markets should be required only to ward off speculative attacks – which, however, are likely to be deterred by the ECB's quasi unlimited fire power.[2] Nevertheless, there have been a few cases of agreed-upon revaluations of currencies in the history of the ERM

II. Thus, exchange-rate adjustments in response to persistent imbalances and changes in the underlying economic fundamentals continue to be available as well.

2.3 Toward a two-level European Currency Community

Until now (and except for Denmark), membership of ERM II has been a trial period in which candidates for full EMU membership had to achieve perfect exchange-rate stability with the Euro. Hence, even if present rules remained in place, the regime would change its function if it were to become part of a "European Currency Community" (ECC) that may permanently include two types of member states – those belonging to the EMU (the future Euro Area) and those whose currencies are related to the Euro through the ERM II. In spite of the heterogeneity of its membership, however, the ECC would be a most powerful player on the global scene. All of its member currencies would form a large "Euro bloc" with the Euro itself at the center and ERM II currencies connected to it by agreed-upon exchange rates and commitments to mutual support against external attack. In other words, its currencies would float together in a global environment of flexible exchange rates, and the Euro bloc, represented by the ECB, would negotiate as a unitary actor in international negotiations about global, multilateral or bilateral currency regimes. Contrary to frequent apprehensions, therefore, Europe's influence in international monetary affairs might even increase by way of the ECC.

One reason for this would be the reduction of internal conflicts if present political tensions between Northern and

Southern EMU states are resolved through flexible coordination in a two-level system of monetary integration. In this context, the members of a more coherent EMU would benefit from the greater effectiveness of uniform ECB monetary policies and perhaps also from the closer coordination, envisaged by the "Five Presidents' Report," between the monetary, fiscal, and economic policies among structurally convergent economies. Moreover, opportunities for further political integration might also allow the EMU to move beyond the present constraints of a rigid hard currency regime toward a wider range of macroeconomic options.

The members of the ERM area, by contrast, would not be required to be economically coherent and structurally convergent. It could include members like Greece and other Southern political economies for whom the present coercion to achieve structural convergence appears economically, socially, or politically intolerable. Other members might resemble Denmark, the only current participant in ERM II; for them, structural convergence on the Northern model and EMU rules may be economically unproblematic, but their sense of political autonomy and democratic accountability may not allow them to submit to the directives, controls, and sanctions of centralized European authorities.

Regardless of their diversity, they all depend on economic exchanges in closely integrated European markets and hence would benefit from protection against speculative currency fluctuations. Moreover, some of them might benefit even more from protection against downward currency speculation in situations where they are trying to fight a wage–inflation devaluation cycle. If the ECC were successful, both ERM and EMU members would enjoy the

economic benefits of being able to trade in the European economic space under nominal exchange rates reflecting the underlying fundamentals of their respective economies.

In order to enjoy these benefits, however, ERM members would have to forswear the temptation of competitive devaluation. Both the central exchange rate and the permissible bandwidth would have to be set and could only be changed by agreement with the ECB, and willful noncompliance would entail exclusion from the ECC. In other words, membership of the ERM area would not relieve states from the discipline of having to manage the conflicting requirements spelled out in the Mundell-Fleming Trilemma.[3] But it would allow them to use their own macroeconomic instruments in managing the trilemma and they would have more political discretion in doing so. Moreover, they would retain the safety option of being able to ask for a readjustment of the central exchange rate in the case of massive changes in economic fundamentals.[4]

Under these conditions, it might not be utopian to think that not only Sweden, Poland, or the Czech Republic, but ultimately also Norway, Switzerland, and perhaps a post-Brexit UK might come to prefer ERM membership to either joining EMU or struggling on their own in international currency markets. In other words, flexible coordination in the ECC could indeed contribute to further European integration and an enhanced European weight in world affairs.

2.4 Assistance in transition

More immediately, however, countries like Greece – for whom EMU has become a prison regime with destructive

impacts on the domestic economy, the welfare state, and the political system – would need assistance in making the transition to ERM II. The need for such support was explicitly acknowledged by the German finance minister in the last paragraph of his "non-paper" of July 10, 2015, in which the possibility of Grexit (described as a "time-out" from EMU membership) was suggested. It proposed that

> The time-out solution should be accompanied by supporting Greece as an EU member and the Greek people with growth-enhancing, humanitarian and technical assistance over the next years.[5]

The size, form, and conditions of such support would have to be negotiated, of course. Nevertheless, its purposes are well identified in the paragraph cited: technical support would be needed to facilitate the installation of a new currency, and humanitarian support would have to assist the rebuilding of minimal public and social services in areas where they have been devastated by austerity requirements. However, the third item, "growth-enhancing assistance," requires comment.

In passages summarized above, I argue against proposals amounting to a "transfer union" that would ease the burdens of Southern adjustment by financial assistance in the context of the present EMU. By relaxing the pressures of fiscal austerity and internal devaluation, transfers would counteract the purposes of structural transformation; and as long as competitiveness is not restored, subsidies to private investments could not induce sustained economic growth. Hence, moral appeals to European solidarity would be undermined by expectations of economic futility. But once Grexit and

nominal devaluation[6] would establish the preconditions of external competitiveness, the availability of financial support for productive investments and essential imports may play the same positive role for economic recovery which the U.S. Marshall Plan played in postwar German reconstruction after a massive devaluation of the Deutsche Mark in 1949 (!). In other words, claims to solidarity and burden-sharing that invoke a common responsibility for damages inflicted by an ill-designed Monetary Union (e.g.,Tsoukalis 2016; Stiglitz 2016) would then cease to be economically counterproductive.

3. Conclusion

In June and July of 2015, none of the three preconditions postulated above was in place. There were no general rules for dealing with state insolvency and the restructuring of public-sector debt; there were no standardized procedures allowing a state to leave the EMU without jeopardizing its EU membership; and there was no institutional framework defining the supportive relationship between the EMU and membership of the ERM II. But if this institutional background had existed, it would have been less plausible to think that the Tsipras government would still have preferred the humiliation of accepting the even harsher conditionalities of another rescue loan to the Grexit option suggested by Germany.

From a Greek perspective, moving from the EMU to ERM II would have allowed devaluation to an exchange rate corresponding to the country's international competitiveness. It would have reduced imports and facilitated exports without the ruinous contraction of aggregate

domestic demand and internal devaluation imposed by the present euro regime.[7] Moreover, with the background guarantees of ECB interventions, the new exchange rate would be protected against speculative attacks triggering a spiral of devaluation, wage push inflation, and further devaluation. This would allow governments and unions to work out a social pact that would plausibly combine wage restraint and social policy commitments in a way that is compatible with sustainable economic growth. At the same time, this scenario would more plausibly allay geopolitical fears in Washington and Brussels than the continuing enforcement of structural convergence with its risk of political collapse could promise.

Beyond that, the institutional preconditions discussed would allow the evolution of a two-level European Currency Community. The first tier would include a structurally more coherent Monetary Union combining a core group of Northern political economies and other members of the present Eurozone which might not wish to jeopardize the gains already achieved through painful structural transformation or may have intrinsic preferences for hard currency policies and export-led economic growth. Their members would benefit from more effective macroeconomic management and from opportunities for greater institutional and political integration. The second tier of a future European Currency Community would include economies for which enforced structural transformation appears unrealistic or that have strong political preferences for a greater autonomy in macroeconomic policy choices, but would still appreciate the benefits of reduced currency fluctuations and of mutual support against speculative attacks associated with membership of the wider community.

Even more important would be the benefits for European integration itself. Allowing member economies to grow in accordance with their structurally conditioned "growth models" would help to overcome the persistent economic stagnation of the Eurozone. At the same time, replacing the rigid institutional shell of a Monetary Union with a flexible two-level Community, and replacing enforced structural convergence with coordination among different political economies, would defuse the potentially explosive North–South conflicts that cannot be politically resolved at the European level. Economically and politically, therefore, Europe would not become weaker but stronger, internally and externally, by the transition from the coercive European Monetary Union to a cooperative European Currency Community, a community that could unlock capacities for European cooperation and political action that are presently paralyzed by the need to suppress the politicization of an irresolvable conflict.

Notes

1. Like George Soros, Mervyn King, and other economists, Stiglitz (2016, 292-203) also suggests that transition would be much easier if Germany and other Northern economies would exit the EMU instead. In my view, this would be politically impossible. But Germany should have an interest in a smaller, structurally more coherent, economically more stable, and politically less conflict-ridden Eurozone – and, hence, should be willing to facilitate the transition to a more flexible monetary regime (Sinn 2014).
2. This assumes that the future Euro Area will be much larger than any individual ERM economy. Under these conditions, the ECB – unlike the

Bundesbank in 1992 – will be able to defeat (economically unjustifiable) downward speculation against any one ERM currency without jeopardizing its commitment to price stability in the EMU. And its willingness to intervene in currency markets would – again unlike that of the Bundesbank in 1992 – be supported by the voice of ERM states in ECB governing bodies. In addition to the buying and selling of currencies, one might also consider currency exchange controls (which the Bundesbank had used extensively in earlier decades) as a useful part of the option set.

3. The trilemma, identified independently by both authors at about the same time, suggests that fixed exchange rates, capital mobility, and monetary autonomy cannot be strictly maintained at the same time.
4. Unfortunately, Finland, whose (highly competitive) economy is suffering from the collapse of Nokia and the rise of EU sanctions against Russia, did not have this option under EMU.
5. http://www.sven-giegold.de/wp-content/uploads/2015/07/grexit_bundesregierung_non_paper_10_juli_2015.pdf.
6. The present Euro regime is trying to achieve the same effect through downward pressures on wages and prices ("internal devaluation"), which are much harder to implement and politically much more controversial – and hence inherently precarious. In purely economic terms, under both types of devaluation, debtors will suffer – which is likely to impede domestic demand led economic growth. But in the case of nominal devaluation, the effect could be avoided by legislation defining a 1:1 conversion rate for domestic wages, prices and debts. The conversion rate for border-crossing transactions would have to be defined in the agreement governing exit from the EMU.
7. Compared to internal devaluation (through wage depression and rising unemployment) whose costs will have to be borne by labor, the rise of import prices caused by nominal devaluation will affect all consumers. In both cases, however, the gain in competitiveness would be nullified through compensatory wage increases.

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Monetary, fiscal and financial sector policy

How risky is the unconventional monetary policy of the ECB? An assessment of (mainly German) critiques

Maik Grabau and Heike Joebges

1. Introduction

Since the financial crisis, the ECB has been trying to ease financial tensions in the Euro Area by using unconventional monetary policy, or non-standard policy as the bank calls it. This policy faces heavy criticism, especially in Germany. Part of the criticism stems from unrealistic expectations about the power of monetary policy: according to some, extremely low and partially even negative interest rates should bust economic activity and especially investment. As this has not happened, the argument runs, the ECB's policy must be unsuccessful and must be stopped. This criticism will not be considered here, as monetary policy can easily dampen economic activity, but not as easily kick-start growth: It can

only set incentives for more investment by decreasing interest rates. Yet, first, commercial banks have to translate these reductions into rates of credit, and second, companies will only invest if they expect that demand will be high enough to allow for profits.

In addition, monetary policy has been confronted with savage austerity measures in the Euro Area: Several countries suffered from high government debt levels, resulting from the financial crisis and the ensuing recession. The pressure to decrease public spending, especially in crisis countries like Greece, Ireland, Spain, Portugal and Italy, resulted in a very contractionary fiscal policy. Such a policy dampens economic activity. Consequently, monetary and fiscal policies aimed at opposite outcomes, blocking their mutual effects.

While the degree of austerity has diminished in the Euro Area and growth seems to turn positive in all member countries, the ECB is continuing its unconventional policy. This has been effective in several ways: It dampened spreads between government bonds of Euro Area countries, thereby easing financial market access for crisis countries' governments. At the same time, it provided commercial banks with long-term liquidity to stabilize banks and support credit supply. This helped to decrease spreads in lending rates among Euro Area countries, and it led to overall low interest rates and returns, even for longer maturities, thereby decreasing investment costs. In addition, these policies dampened the value of the Euro, thereby supporting Euro Area exports.

Nevertheless, all these measures imply risks. Critics point to

- distributional consequences: the policy harms poorer savers and benefits wealthy asset holders;

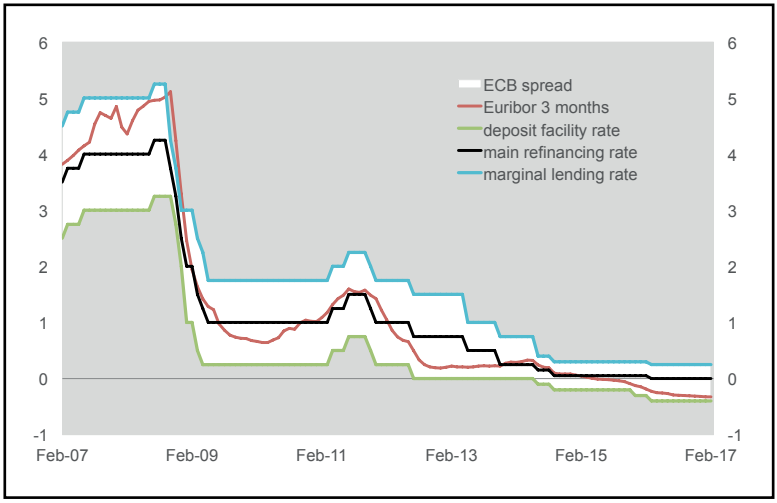
- the risk of asset bubbles in equity and housing,
- decreasing profits in the banking system, and weakening banks, leaving them less prepared for fresh crises, and
- decreasing profits of companies offering life insurance and pension provisions, potentially provoking insolvencies.

The article will explain how relevant the different risks are. Yet, before judging their relevance, it will briefly explain the positive effects of the ECB's unconventional policy.

2. Positive Effects of unconventional monetary policy

Unconventional policy goes beyond a policy rate close to zero (see "main refinancing rate" in figure 1). It includes the provision of more and longer-term liquidity to commercial banks compared to normal times. To prevent commercial banks from hoarding this liquidity, they have to pay for depositing excess liquidity at the ECB (see the negative "deposit facility rate" in figure 1). In addition, the ECB purchases corporate and government bonds on secondary markets.

Figure 1: ECB policy rate and related rates



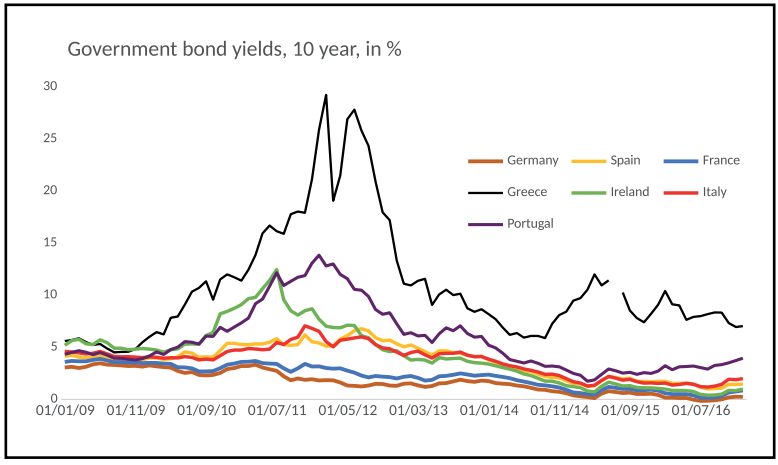
Source: ECB via Reuters Datastream, own presentation.

As can be seen in figure 2 (below), returns on government bonds started to increase for Greece at the end of 2009. Irish and Portuguese yields seemed to mimic this behaviour, followed by those on Spanish and Italian bonds. Bond returns reflect refinancing costs for governments, implying that servicing the debt became more costly for those countries that anyway faced several economic problems. Figure 2 shows the increase of yields for those countries up to mid-2012, and the later decrease of spreads until 2015. The declining yields have probably rescued the Euro and, furthermore, contributed to easing the fiscal burden on crisis countries' governments.

In order to decrease the spread in yields between different Euro Area countries, the ECB reverted to unconven-

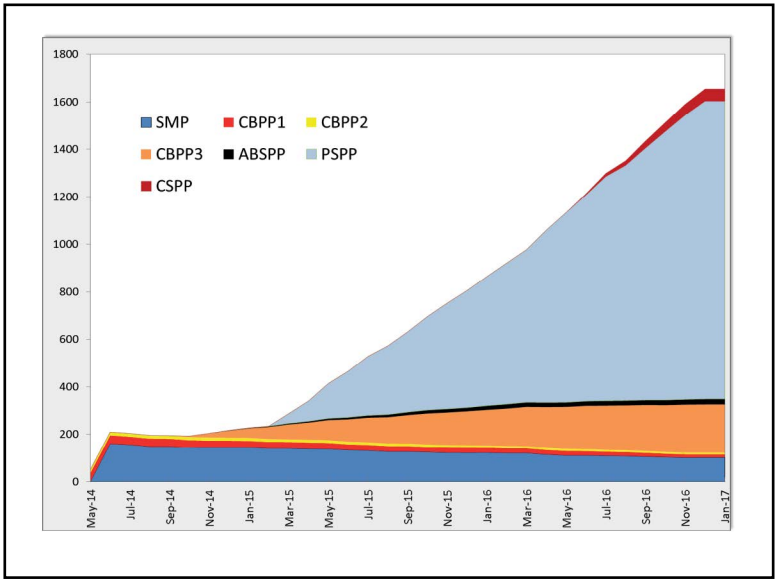
tional measures: An important factor was ECB president Mario Draghi's announcement to support the Euro with "whatever it takes" in July 2012, followed later by purchases of government bonds (SMP, PSPP). As the ECB purchased government bonds on secondary markets, it contributed to decreasing the spreads in yields and – at the same time – pushed liquidity into the system (figure 3), not only to financial institutions, but also to the non-financial sector. While the policy of purchasing government bonds to decrease spreads in yields was successful until 2015, spreads on bond returns have started to widen again since then (figure 2).

Figure 2: Yields on government bonds of selected euro area countries



Source: ECB, own presentation.

Figure 3: Liquidity effects of the ECB's bond purchasing programs in billion euro

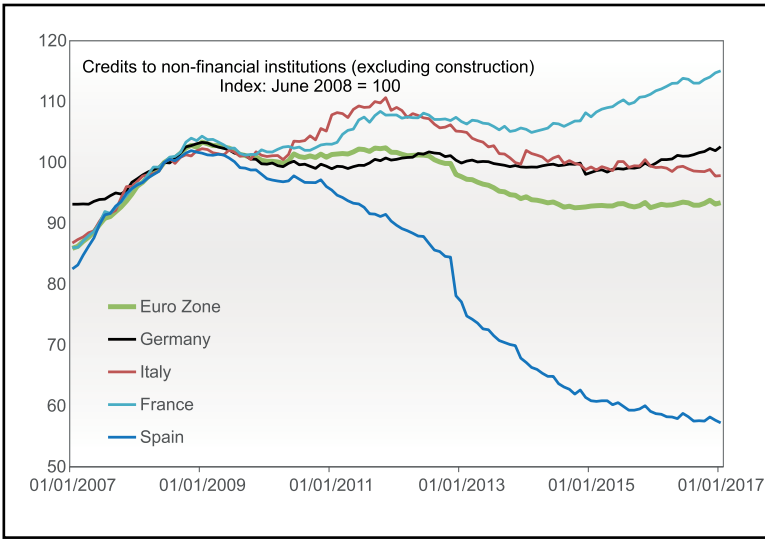


Note: SMP: Securities Markets Program, PSPP: Public Sector Purchase Program; CBPP1-CBPP3: Covered Bond Purchase Programs, ABSPP: Asset Backed Securities Purchase Program)
Source: ECB via Reuters Datastream, own presentation.

Besides supporting financial access for governments, the ECB tried to stabilize commercial banks by providing them with more and more longer-term liquidity at low costs. In order to remove incentives for them to deposit this liquidity at the ECB, and rather use it for credit supply, banks have had to pay for excessive deposits since June 2014 (figure 1, deposit facility rate). These measures have contributed to banking system stability and supported credit supply. Together with

negligible costs for accessing liquidity, lending rates have decreased. The ECB stresses: "Bank retail lending rates have declined steadily since 2014 and their dispersion has narrowed considerably across the euro area." (ECB 2017, p. 41). Lower interest rates and lower yields on financial assets, especially for longer maturities, are supposed to decrease investment costs and support economic activity. Figure 4 shows that the ECB managed to stabilize credit developments for the Euro Area on average, but not for all countries, as the decreasing credit volume for instance in Spain demonstrates. The ECB deems these unconventional measures necessary for the transmission of monetary policy and for ensuring financial stability.

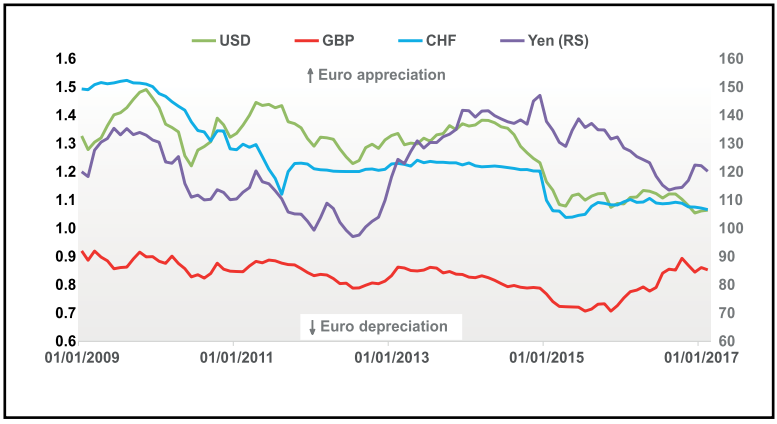
Figure 4: Credit supply in the euro area and selected euro area countries



Source: ECB via Reuters Datastream, own presentation

Figure 5 shows that the ECB's policy has also weakened the Euro's external value, especially against the Swiss Franc, but also against the US-Dollar, yet hardly against the Japanese Yen and the British Pound. The Pound suffered from the Brexit debate. Even though exchange rate policy is not part of the ECB's mandate, the dampening effect on the currency's value via low interest rates supports exports.

Figure 5: The external value of the euro against selected currencies



Source: Reuters Datastream, own presentation

3. Distributional consequences of the ECB's monetary policy

Critics point to unwanted distributional consequences of the ECB's unconventional monetary policy. This is a valid point, as central banks' actions always imply distributional

effects. Interestingly, these effects caught less attention up until the financial crisis. The simplest argument is that low or even negative interest rates favour borrowers over lenders and savers. This critique is correct, yet this is one of this policy's intended effects: it seeks to discourage savings and encourage spending so as to boost economic activity.

Opponents in Germany may argue that its economy does not require such a low level of interest rates and that it is hurting German savers more than necessary. Implicitly, they are criticizing the fact that the ECB can only try to optimize the policy rate for the entire Eurozone, focusing on average economic developments. This is a problem of any common currency area. Yet, this critique should be aimed at the absence of alternative policy instruments that might compensate for the lack of national monetary policy. National governments did not or could not use fiscal policy to a degree that would have been able to counteract divergent economic developments. The lack of complementary or alternative instruments in the Euro Area to substitute for the loss of national monetary policy attracts illegitimate criticisms of the ECB, thus treating it as a scapegoat (see the discussion of instruments in other contributions to this book).

Given the current institutional setup, the ECB can only set interest rates for the average Euro Area. The resulting interest rate level is indeed low for Germany, and very unattractive for savers. Yet, low levels do not necessarily signal that interest rates are too low. Even though the European Commission expects that from 2016 onwards, all Eurozone economies (and even all EU members) will have been growing in real terms, inflation in the Euro Area has only very recently been closer to the ECB's target of close to

but below 2 %. Euro Area inflation measured by the HICP reached 1.8% in January 2017, and 1.9% in Germany. As special effects stemming from recent energy price increases are behind these higher figures, but will fade out in the coming months, inflation expectations of professional forecasters continue to expect HICP inflation clearly below 2%, in line with the ECB's own forecasts for the coming years.

Second, the relevance of the effect is unclear, as Thomas Fricke has pointed out recently in a Social Europe Blog (Fricke 2017). He subtracts about 50% of the German population with close to no savings or even negative savings (i.e. indebted households) and argues that most savers will not mainly retain their money in a bank account but benefit from the rise in equity prices.

Third, even if his calculations underestimate the effect's relevance, it is interesting to note that critics were less concerned during the long phase when savers and lenders in Germany benefitted from too high (real) interest rates, and borrowers suffered. From the introduction of the Euro up to the financial crisis, (real) interest rates were above the levels justified by economic developments in Germany. In addition, negative real rates are not something new: Real returns on short-term German savings deposits were negative during the 1970s and in the early 1990s

Nevertheless, not only low or negative interest rates have distributional consequences, but also the ECB's purchase of government bonds and corporate bonds. Adam and Tzamourani (2016) try to simulate the effects of asset price increases in bonds, equity, and housing separately for the Euro Area, as all these prices may rise as a consequence of the ECB's unconventional policy. Assuming for each asset

an increase of about 10%, they find on average no relevant distributional consequences for bond price increases in the Euro Area, while the increase in equity prices mainly benefits the upper 5% of the population with already high levels of wealth. Regarding this effect, the ECB contributes to wealth inequality by furthering share price inflation. Yet, the positive effect on housing prices rather benefits the middle class (and lower classes, should they own their home), for whom housing wealth constitutes a higher share of overall wealth than for wealthy individuals. In countries with high home ownership ratios, this effect may even dampen overall inequality.

In addition, even the Bundesbank argues that a comprehensive assessment of distributional effects should also incorporate the positive effect of the ECB's policy on employment and income that might otherwise have suffered (Deutsche Bundesbank 2016). As better employment and income developments benefit employees relying on wage income, the ECB's policy might even decrease income and wealth inequality in the Euro Area. In addition, low returns on government bonds increase the policy room for manoeuvre for financing social policy and transfers to low-income households. Overall, the criticism about increasing inequality appears unjustified.

4. Risks of asset bubbles in equity and housing

Another criticism often voiced concerns asset bubbles, especially bubbles in equity and housing. The Bundesbank has recently published a study, according to which housing prices have increased in Germany by 25 percent since 2010.

Yet, concentrating solely on the seven biggest German cities, the increase amounts to more than 60 percent (Deutsche Bundesbank 2017). This raises the fear of local bubbles. To avoid asset bubble formation at national level is especially important for housing, as bursting bubbles can have long-lasting negative effects on economic activity.

While this is a risk, it should not be overstressed: First, increasing equity and housing prices are important channels for the transmission of monetary policy. With increasing prices, companies' values increase, improving equity to debt ratios and allowing for easier credit access. Second, a rise in housing prices does not directly signal bubble formation. Instead, housing prices should go up if interest rates fall and are expected to stay at low levels, at least according to theoretical models. This constitutes a fundamentally justified price increase. Third, prudent financial regulations in a broad sense can address and prevent asset bubble formation, even in the face of low financing costs (Dullien et al. 2015).

The EU has already reacted and enforced the national implementation of new mortgage credit regulation: Since then (March 2015 for Germany), banks have to factor in the repayment capabilities of potential borrowers after a future rate increase. The idea is that nobody should get a loan who can only service the debt in periods of extremely low rates, but would default in the event of a rate rise.

Consequently, the risk of asset price inflation is not a convincing argument to end unconventional monetary policy. House price increases may increase social tensions between home-owners and non-owners and may contribute to rising rentals; yet, there are better tools to counteract these developments than monetary policy. Adequate financial

regulation can prevent bubble formation. And the local housing price increases in Germany rather call for a greater social housing supply of low rent flats in bigger cities and reduced incentives to use housing as a speculative asset.

5. Decreasing profitability of banks

Another, more relevant criticism concerns the negative effect on banks' business. Savings banks in particular benefit from higher nominal interest rate levels and this tends to increase banks' profit margins, as proven empirically. Current low to negative rates have decreased their margins.

Even worse, holding customers' deposits is even proving costly for banks: Commercial banks have to hold a fraction of their deposits at the ECB. If they hold more than the required amount, which they may do as holdings at the ECB are considered extremely safe and liquid, they have to pay for it, as the deposit facility rate is negative. Consequently, banks may lose money from deposits, even if they pay zero interest rates to their clients. Banks try to shift these costs to their clients, and have been successful in making companies pay, and, in the interim, even (local) governments. Yet, they cannot easily pass on negative rates to private households, as these have the option to hold money as cash instead. In addition, legal barriers may impede this: In Germany, for example, the Civil Code (§ 488 (1) BGB) allows zero, but not negative nominal interest rates for bank deposits, at least according to prevailing interpretations. Banks try to partly compensate for costs by increasing account maintenance fees, yet this can only be a sub-optimal solution.

In addition, banks relying traditionally on transforming different maturities (channelling short-term deposits into long-term credit), benefit from a steep yield curve, i.e. from strong differences between long-term and short-term rates. Yet, the ECB's policy has contributed to a rather flat yield curve, and even on purpose: Long-term rates are close to low short-term rates, in order to allow for low credit costs and thereby incentivise investments. While this is positive for companies, it harms the banking system that relies on revenues from maturity transformation. The ECB shows in a study that margins based on maturity transformation have more or less halved since 2014 (ECB 2017: 45).

These developments, together with higher capital requirements as a response to the financial crisis, explain the decreasing profit margins in the banking system. According to a calculation by Bain & Company, the return on equity has halved for German banks, from about 4 % before the financial crisis to only 2% in 2012-2015. While the return on equity has also decreased for French banks by more than 50%, they still show a rate of return slightly above German pre-crisis levels (Bain & Company 2016, p. 7). Nevertheless, this loss in profitability is a worrying outcome for all banks in the Euro Area. A continuation of the low interest rate environment will weaken the banking system, reducing their resilience to future shocks.

6. Decreasing profitability of life and pension insurance companies

Similarly, life and pension insurance companies suffer. Owing to regulation, these companies mainly invest in safe

assets. Consequently, government bonds carrying a low risk play an important role as assets in their portfolio. Yet, returns on government bonds considered safe havens, such as German Bunds, have fallen and even turned negative in the wake of the ECB's unconventional policy. While negative rates are more prevalent among shorter maturities, figure 2 shows that even 10-year government bonds became slightly negative during the second and third quarters of 2016.

This would not constitute a problem if life and pension insurance companies could roll-over the negative rates to their clients. But this is legally impossible: Many contracts for retirement provisions and life insurance have a guaranteed (minimum) interest rate, set by national authorities. In Germany, the federal ministry of finance has reduced the minimum interest rate that companies have to offer several times since 2000, down to 0.9% in 2017. Yet, this reduced rate only applies to new life insurance policies or pension contracts, while the old contracts may offer rates above 4%. Consequently, companies offering life insurance and pensions suffer from the low and negative interest rate environment. The longer it takes for rates to recover, the higher the probability of decreasing profits and even insolvencies.

7. Conclusions

Alongside improving economic indicators for the Euro Area, the ECB is continuing its unconventional policy as HICP inflation has not yet clearly reached target inflation. This policy has been effective: First, it decreased spreads between government bonds of Euro Area countries and eased

financial market access for crisis countries. Second, it stabilized commercial banks by providing them with long-term and almost cost-free liquidity, coupled with incentives to supply credit to the economy. This contributed to low lending rates, even for longer maturities, and declining spreads between euro area countries, thereby stabilizing the Euro Area financial system. In addition, this policy dampened the Euro's external value, thereby supporting exports.

Critics are right in pointing to the risks involved. Yet, some of the criticisms seem unjustified. First, unconventional monetary policy does not seem to increase wealth inequality but the opposite. Second, the risk of asset bubbles in equities and housing could be (and has been) addressed by sensible regulation. Even so, unconventional policy weakens the financial sector. Decreasing returns for the banking system and companies providing life insurance and pensions may lay the ground for future problems in this sector, if the low interest rate environment persists. Yet, in order to avoid such a destabilization, a swifter recovery of the Euro Area should be supported by other means such as fiscal measures, not necessarily by a different stance of monetary policy.

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EMU architecture and governance of finance

Helene Schuberth[1]

1. Introduction

While the global financial crisis that emerged in 2007 and quickly spread across the globe was triggered by events in the US mortgage and banking sector, its repercussions were felt particularly severely in Europe. The European banking sector was hit hard given its insufficient degree of external diversification owing to a strong bias towards the US. Banks and the structured investment vehicles that were linked to them had invested heavily in the US mortgage market. As interbank markets broke down, central banks had to step in and governments eventually provided wholesale guarantees and capital for financial institutions. The socialisation of private losses was unprecedented in recent economic history and added to the surge in public debt.

With the increasing length of the crisis, the deep structural flaws of the regulatory architecture of the Euro Area became fully visible. Indeed, the crisis would most likely have materialised even without the financial disruption in the US at some time in the future. With the onset of the self-fulfilling liquidity runs on some Euro Area sovereigns in 2010, the crisis also revealed institutional design failures in the European Monetary Union (EMU) – some of them related to banking and financial sector regulation – that were tested in the extreme and which exacerbated the financial crisis.

This contribution discusses governance and regulatory reforms in the European Union with a special focus on the reforms related to the better functioning of Monetary Union (MU) and it tries to identify reform gaps and the challenges ahead. Section 2 asks why European banks were so severely affected by the crisis. Section 3 outlines how the governance of finance in general added to the design failures in MU that are at the heart of the so-called euro crisis. Section 4 discusses the rationale of the Banking Union and other proposals that contribute to a better working of MU. Section 5 outlines conclusions.

2. Why were European banks so heavily affected by the crisis?

When considering the role of European banks before the crisis, three features stand out.

First, the crisis has fundamentally challenged the narrative, predominant in policy circles, of European banks primarily funding the real economy and being less engaged in the opaque

shadow banking activities known in shareholder value economies. The dichotomy is not so much between arms-length, market financing (i.e. US, UK) and bank-based financial structures (i.e. Germany) but between traditional retail banking activities and market-based business models that focus on high-risk and high-leverage activities. European banks pursued aggressive expansion strategies and became global, systemically important financial institutions. Starting in the 1990s, the historically prevalent bank-intermediated financial system in Europe had undergone, via policy-induced deregulation and innovation and legislative initiatives promoting integration, a process of fundamental transformation towards the development of liquid, securitized financial markets, supported by a large-volume, integrated wholesale market that was increasingly used by banks to leverage up their balance sheets at low cost. European banks were the most reliant on wholesale funding worldwide, much more so than U.S. banks. At the height of the crisis, large European banks were funding about two-thirds of their assets in wholesale funding markets. The wholesale market is not supported by any official safety net and is inherently fragile. It comprises unsecured short-term debt securities issued by banks, the unsecured interbank debt market, refinancing operations with the European Central Bank (ECB), as well as repurchase agreements ('repo market'). Initiatives to integrate the repo market which accounted for an important part of the wholesale market were key for the rapid growth of this funding source of banks. Between 2001 and 2008 the repo market tripled in volume, to €6 trillion. By 2008 its size was similar to that of the US (Gabor 2016).

The increasing mix of traditional and capital markets banking in Europe had important systemic implications

that were widely overlooked before the crisis. Securities dealing, over-the-counter derivatives and repo markets are based on margin accounts and the need for collateral, such as government bonds, which are the most important collateral by far in repo transactions in Europe, as well as other, often securitized assets.

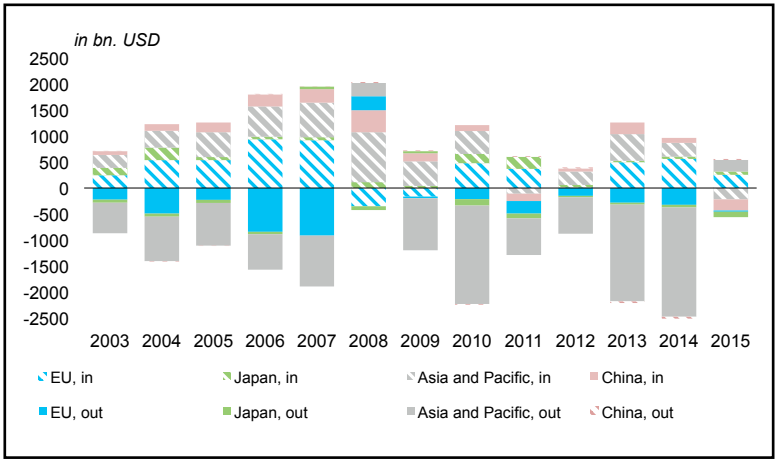
Repos were usually portrayed as transferring and mitigating risk. Banks borrow short term against collateral. If the bank that has borrowed cash defaults, the lender of cash is not exposed to the credit risk of the borrower as it can sell the collateral. But when banks are unable to meet collateral calls because of significant mark-to-market price shifts of assets that serve as collateral, liquidity crises emerge (Blundell-Wignall 2011) that may well degenerate into solvency crises. The technique of re-hypothecation allowed multiple use of the same collateral. Hence, different financial institutions are connected through just one financial instrument and are exposed to its price volatility. If its price falls the institutions that have accepted the instrument as collateral make margin calls on their counterparties: each borrower has to post additional collateral or cash. Or haircuts are increased. This may lead to fire sales and further margin calls and systemic risks may be spreading through collateral networks.

Systemic risk may also be relevant when securitized instruments are involved. In principle, the more securitized credit and derivative contracts are, the greater the likelihood of liquidity crises (Garber and Folkerts-Landau 1992) and the more the financial system becomes globally interconnected and opaque. It became increasingly difficult to trace risk transfers. Securitization has played a role in amplifying systemic risk by facilitating excessive leverage and

risk concentration across the financial sector (Acharaya et al. 2013). Further, even not so large banks turned out to be systemically important.

Second, widely unnoticed before the crisis, global European banks increasingly engaged in round-tripping across the Atlantic. Their US branches and subsidiaries borrowed large amounts of US dollars through the US money markets, transferred them to headquarters in Europe and invested them in asset-backed, particularly mortgage-backed securities and structured products generated by securitization via the US shadow banking system (Shin 2012). Or to put it simply: The US banks provided the European banks with the funds that allowed the latter to purchase high-yielding US safe assets, that turned out to be not that safe. In the crisis these apparently liquid assets became illiquid while the apparently stable funding base evaporated in a flash (Ramskogler 2014). The significance of this round-tripping is well visible in the US capital accounts data. In the years before the crisis gross capital inflows from Europe to the US grew rapidly in parallel to the surge in gross capital outflows (Chart 1).

Chart 1: Gross Capital Flows to and from the US



Source: U.S. Bureau of Economic Analysis.

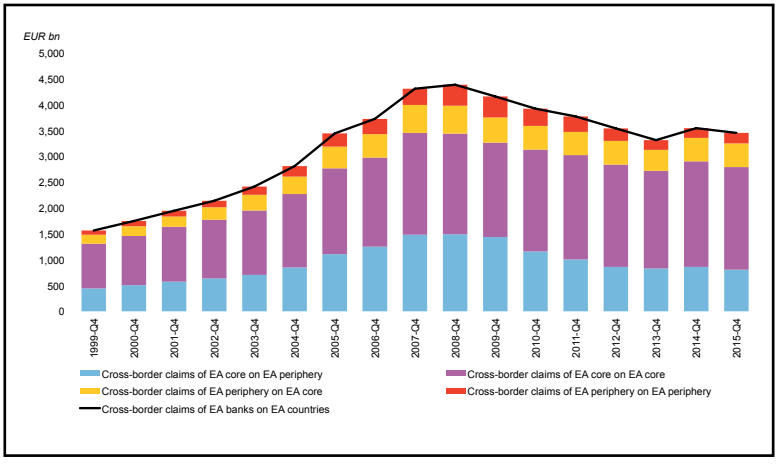
In 2007 the recycling mechanism explained above came to a sudden halt, flows of funds dried up and central banks and fiscal authorities had to step in at an unprecedented scale.

The third feature that stands out was the explosive growth of cross-border banking within the Euro Area – facilitated by the elimination of currency risk within it following the adoption of a single currency (see Chart 2). Cross-border takeovers were much less important and the retail banking markets remained quite fragmented. This increase in cross-border flows mainly reflects cross-border lending of the core Eurozone countries' banks to the banks of the periphery countries while the latter, given inadequate regulation and an impaired intermediation function of banks, fuelled unsustainable credit, property and consumption booms. They were partly directed towards unproductive uses. In addition,

core countries' banks and insurance companies in particular invested in sovereign bonds of the periphery, practically equalising yields across Euro Area countries. Intra Euro Area capital inflows to peripheral countries facilitated real effective exchange rate appreciations via an economic boom that further widened unsustainable current account deficits (Chen et al. 2012). This was particularly harmful given the various shocks to the periphery countries' trade balance originating outside (i.e. the rise of China) and inside (excessive wage moderation in surplus countries) the Euro Area in the years before the crisis.

Severe capital flow reversals – comparable to the sudden-stop events known from emerging market currency crises rather than sovereign debt crises (Merler and Pisani-Ferry 2012) – started in 2008 that could only partly be mitigated by Eurosystem financing and program financial facilities. The exposure of Euro Area core countries' banks to the periphery countries did not stabilise until 2012. Ultimately, the ECB's 'whatever it takes' stance was decisive in mitigating the flight to safety and in stabilising sovereign bond yields of the stressed economies at a rather low level. This commitment was so effective that markets never tested it (see for details Herr in this volume).

Chart 2: Cross-border claims of Euro Area banks on EA core and periphery (intra-EA)



Note: Euro area periphery consists of Cyprus, Greece, Ireland, Italy, Portugal and Spain. Euro area core consists of the remaining EA countries, whereby Estonia, Latvia, Lithuania, Malta, Slovakia and Slovenia do not report data to the BIS.
Source: BIS locational banking data.

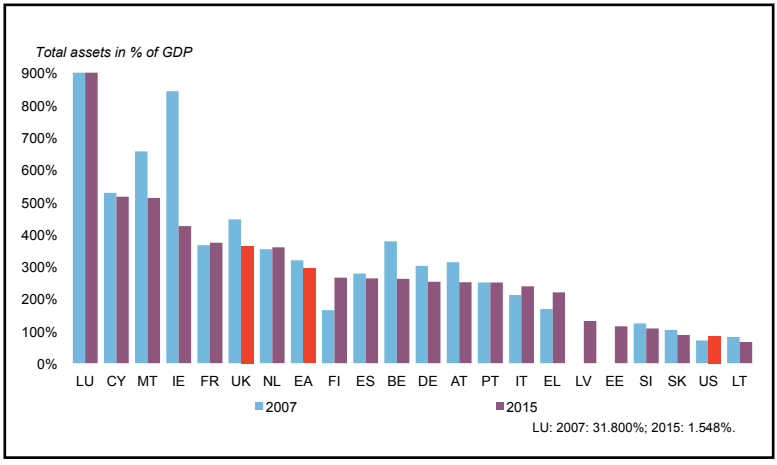
3. Design features of the Euro Area and the role of banks

What were the main design features of the Euro Area's architecture related to banks that created a breeding ground for the severe and lasting crisis episodes in Europe?

3.1 Global banks – national supervisors

First, European banks rapidly expanded cross-border integration, while they remained supervised at national level. Financial conglomerates operating under multiple jurisdictions emerged with complex, opaque organisational structures. The gap between the geographical exposure of the banks and their supervision at national level is indicative of the regulatory deficiencies before the crisis, because it created above all opportunities of regulatory arbitrage and regulatory capture. Further, national banking systems are large relative to the size of a country's economy and of the respective fiscal backstops (see Chart 3). Regulators were often willing to relax rules and exercise regulatory forbearance in order to improve the competitive advantage of the respective domestic banking system. Too often they did not account for the negative cross-border spill-overs of their activities. The fact that the focus was on microprudential supervision alone fundamentally added to these deficiencies. No specific consideration was given to systemic risk.

Chart 3: Size of the banking sector in EA, UK and US



Source: ECB, Eurostat, FED St. Louis.

The lack of a vigorous supervisor at European level had other severe implications. The rapid shift to market-based (shadow) banking activities and the associated complex intermediation chains overwhelmed national supervisory capacities.

With the outbreak of the crisis, the national character of bank rescue operations in general strengthened the sovereign/bank nexus: Fiscal backstops were only provided nationally. Private losses were shifted to the respective country's public sector. This has generated (the potential of) rising risk premia for (previously sound) sovereigns of economies with weak banking systems in anticipation of a bailout (De Grauwe and Ji 2012). In contrast, in the US a regional banking crisis does not negatively affect the ratings of a regional state because bank rescue and resolution are a federal competence. In the absence of a proper (cross-border)

resolution framework for banks, a far smaller number of distressed banks was liquidated in Europe than in the US, which has a long tradition in bank resolution.

3.2 Sovereigns and banks in monetary union issue debt in 'foreign currency'

The second design feature that puts severe stress on the stability of the Euro Area is related to the fact that the sovereigns and banks of the 19 Euro Area countries issue debt "in foreign currency". All Euro Area countries have their own national central banks that keep their own balance sheets and, unlike "stand-alone countries" like the US, member countries of the MU issue debt in a currency they no longer control. As a result, governments cannot guarantee that liquidity will always be available to roll over government debt (De Grauwe and Ji 2013). Thus, the sovereign credit of the (weaker) member states is more exposed to the risk of liquidity runs, contagion and self-fulfilling default. Indirectly, via the sovereign/bank nexus, this has also repercussions on banks, as doubts concerning their exposure to the sovereign may arise more easily, translating more quickly into funding problems. Moreover, similar to (weaker) sovereigns, banks in (weaker) Monetary Union countries are directly affected: they lack an implicit guarantee from their central banks that cash will always be available under the central banks' lender-of-last-resort function. Thus, these banks are more exposed to the risk of bank runs. At the same time, a common deposit insurance is still lacking, while depositors become increasingly aware how easy and cheap it is to transfer deposits to

banks in other (stronger) member states, given the success of the Single European Payment Area (SEPA).

One direct effect is financial fragmentation in the Euro Area via tightened credit supply conditions for the crisis countries. This generates a downward spiral of deleveraging, contracting economic conditions, rising non-performing loans that weigh on new lending, a recession-induced deterioration of the fiscal position and capital flight.

3.3 'Shadow/fiscal nexus' is destabilizing government debt markets

Related to the second, the third inherently destabilising feature of the Euro Area that should deserve more attention is the way in which the repo market, the most important setting for shadow banking activities in Europe, is connecting the fate of sovereigns with the fate of large banks (or non-bank intermediaries belonging to shadow banking entities) that are key nodes in collateral networks (Gabor and Ban 2016). This design feature related to governance of the repo market in Europe amplifies the second.

As indicated above, reliance on short-term repos that are to a large part collateralised with government bonds turned sovereign debt into a crucial tool for financing banks' expansion strategies. Thus, highly liquid sovereign assets became important for ensuring (international) funding for those banks in particular that have a weak deposit base. At the same time, this makes the 19 individual sovereigns in the Euro Area dependent on the collateral quality of their debt, which may be disconnected from fiscal sustainability and fundamentals – the familiar narrative. Rather, the fortune of

sovereigns hinges, via the repo market, on shocks to the short-term funding of global banks, on the tightening or loosening of collateral policies of private repo actors and central banks, moreover on pro-cyclical ratings, as well as on the amplifying effects of credit default swaps that were driving up interest rates of peripheral countries, thus exacerbating the crisis (Delatte et al. 2012). In a highly liquid government bond market like that of the US, one backed by the central bank, the 'shadow/fiscal nexus' is probably less relevant. During the crisis, US treasuries preserved their 'safe asset' collateral status. But in a currency union with many sovereigns not backed by their central banks, individual sovereigns are at the mercy of the multiple actors in the repo market.

4. Financial sector regulation and the rationale of the banking union

Following the regulatory reform agenda of the G-20 that started its work in late 2008, the EU has implemented a wide range of regulations through many legislative acts (Schuberth 2013). The main focus was to make banks more resilient by introducing, above all, higher capital ratios for all, and in particular, for large, systemic banks. Large parts of the previously opaque derivatives market were forced to migrate to central counterparty platforms (CCPs). Macroprudential instruments have been introduced that should mitigate pro-cyclicality in bank lending.

But the crisis taught Europe the lesson that, in addition to regulatory reforms, MU governance needs a complete overhaul – in particular in the areas of a Fiscal, Social and

Banking union. The latter is considered as the main remedy for breaking the 'diabolic' feedback loop between national banking and sovereign risks. But governance reform is closely interlinked with regulatory reform. Both have to be implemented in a comprehensive and consistent manner. In the following, the major governance reforms are discussed. We explore whether they may fix the design failures laid out in Section 2 and whether they are consistent with the regulatory reform agenda.

4.1 Governance reforms in EMU – an overview

Governance (and regulatory) reform so far has mainly addressed the design failures, indicated in 2a (global banks – national supervisors). The transfer of supervisory and resolution powers to the central level via Banking Union was meant to alleviate 2a, and – partially – 2b (sovereigns and banks in monetary union issue debt in 'foreign currency'). So far, reform has done little to lessen the destabilising effects stemming from 2b and the 'shadow/fiscal nexus' (2c) via the repo market. Options would be new regulation commanding countercyclical collateral policies that were strongly procyclical during the crisis, financial transactions taxes for repo transactions, taxation of repo-based bank liabilities, or, more far-reaching, providing backstops for repo markets or pooling sovereignty via euro bonds, the latter being probably the most effective cure for the design failures of the Euro Area in general.

But governance reform has strongly relied on one phenomenon identified as the single most important

impediment to recovery in the Euro Area, and in particular in the periphery: The sovereign/bank nexus. The tight financial linkages between states and banks set in motion a vicious circle where banking and sovereign crises exacerbate each other. The sovereign/bank loop works two ways. First, systemically important troubled banks might trigger a surge in the spread on debt of a previously sound sovereign because of the potential for a government-financed bank bailout or because of lower tax revenues resulting from severe economic downturns caused by problems in the banking sector. Second, if there is doubt about fiscal sustainability and spreads of government bonds are rising, the risk premia of previously healthy banks may rise in parallel.

Several proposals have been put forward to diminish this nexus and address the embedded design failures of MU.

4.2 Banking Union

First and foremost is the creation of a Banking Union. To many this seems to be an initiative born out of the experience of the crisis. But it is in fact based on an older debate. During the preparations for the Maastricht Treaty in the early 1990s, there was already the strong conviction that a single system of banking supervision at European level was a key element in the construction of MU (James 2013). While the proposal was vetoed at the time, Article 127(6) of the Treaty on the Functioning of the European Union eventually allowed the European Council to confer the task of prudential supervision upon the ECB.

At the height of the euro crisis in summer 2012 the EU decided to establish a Banking Union – following numerous calls by economists and policy-makers – by setting up a Single Supervisory Mechanism (SSM) as of November 2014. Within the SSM, the ECB is the primary supervisor of the Euro Area's biggest banks. It directly supervises the largest 129 banks, accounting for approximately 85% of banking assets of the area, and indirectly all the banks in the area. The smaller institutions (well over 3,000 of them) continue to be supervised by national supervisory authorities, subject to ECB oversight. All Euro Area member states participate in the SSM as a rule but other EU member states may choose to be included.

The first pillar of Banking Union, the SSM, is a highly centralised scheme. The second pillar is the Single Resolution Mechanism (SRM) that aims to ensure that failing systemically important financial institutions can be resolved in an orderly manner without burdening taxpayers. In general, the SRM entails a more complex division of responsibilities between European and national authorities. At the beginning of 2016 the Single Resolution Board (SRB) was given full responsibility for dissolving ailing banks within Euro Area countries. The SRB can press ahead with resolution measures even if the national authorities are reluctant, but the involvement of the European Commission and Council makes for a complex decision-making structure, which is seen as drawback of the SRM regime (Veron 2015). To ensure the efficient application of resolution tools, a Single Resolution Fund (SRF) has been established. During a period of transition, the SRF consists of national compartments coexisting with a mutualised fund, until full

mutualisation is achieved in 2024. Then it should reach a total size of €55 billion funded by contributions from banks. Given the size of European banks' assets, which reached more than €30 trillion euro in 2016, the fund is considered to be extremely under-sized. Another concern is the lack of a common backstop during the transition period and the continued lack of a European fiscal backstop. Setting up a credible common backstop for the SRF during this transition period features as one of the priorities indicated by The Five Presidents' Report (EC 2015).

The Bank Recovery and Resolution Directive (BRRD) sets the frame for the resolution process. Bailing-in shareholders and uninsured and unsecured creditors for a minimum amount of 8% of total bank liabilities before any funds from the SRF may be injected into a bank under resolution has been mandatory since 2016. The bail-in instrument is usually seen as a huge step forward. It should reduce the implicit state guarantee 'too-big-to-fail' (TBTF) banks are enjoying by substantially diminishing the expectation of a taxpayers' bailout. It should be mentioned that public interventions for the rescue of banks have often resulted in a further concentration of the banking sector through mergers (Zhou et al. 2012); this has further aggravated the 'too-big-to-fail' problem. Further, moral hazard should be eliminated by forcing shareholders and creditors to bear the losses on the risks they have taken. Finally, bail-in could to some extent help to break the bank/sovereign nexus.

But there are problematic features as well that will have to be fixed. Bail-in is a useful tool for dealing with idiosyncratic bank failures but difficult to implement during a systemic crisis. If banks hold a large amount of bail-in-able debt secu-

rities – which is the case in the Euro Area (Pigrum et al. 2016) – intra-sectoral connectedness may lead to contagion in the case of large-scale bail-in operations. The quite substantial share of wealthy households in holdings of bail-in-able debt instruments may prompt political pressure to avoid bail-ins. By the end of 2016 the endeavour to bail in creditors was only partly successful, as the Italian government decided to bail in holdings of institutional investors, but to bail out the roughly similar-sized volume of all retail investors' holdings of subordinated bail-in-able bank debt.

The new framework of resolution and bail-in implies a major shift to more balanced burden-sharing and to sounder incentives for investors and bank managers. But it is no universal remedy for the 'too-big-to-fail' problem, which requires reducing the complexity and interconnectedness of banks and limiting the size of extremely large bank groups.

The fact that some basic elements of a Banking Union (centralised supervision – matching the perimeter of banks with the regulatory perimeter, reducing risk of regulatory capture at national level, bail-in regime) have been put in place is a huge step forward. It is probably the most significant policy development in Europe since the creation of the Euro. But with only the first and the second pillar in place, the link between banks and sovereigns has not been fully broken. An important ingredient of the Banking Union still needs to be implemented: the European Deposit Insurance Scheme (EDIS). This third and long-awaited final pillar should guarantee that the level of depositor confidence in a bank should not depend on the bank's location. It should minimize the risk of panic mass cash withdrawals caused by the fear of bankruptcy and the risk of capital outflows from

a country in crisis. EDIS would develop over time and in three stages: first a re-insurance stage, then a co-insurance stage and, finally, a full European system of deposit guarantees, which is envisaged for 2024.

As risk-sharing among Euro Area countries is potentially involved, the proposal is faced with fierce opposition and its implementation is made contingent on various reforms that help reduce risks in banks' balance sheets, such as reducing the large stock of non-performing loans. But one other such prerequisite that is called for is a change in the regulatory treatment of sovereign bonds, i.e. by introducing non-zero risk weights for the sovereign exposure of banks (ESRB 2015). This might be dangerously reinvigorating tensions in the Euro Area so that any reform has to be considered very carefully. If at all, then such a reform should take place only after the successful introduction and initial market development of a Eurozone-wide low-risk asset (see chapter 4.3 below) and comprise concentration-based rather than credit-risk-based non-zero risk weights. In this context, an uneasy stalemate has evolved by linking implementation of EDIS to the regulatory treatment of sovereign exposures. Another criticism of the envisaged EDIS, which, however, applies to current national deposit insurance schemes, too, is the unequal treatment between (wealthy) holders of bail-in instruments and (wealthy) deposit holders, who in principle can get insurance for a multiple of the €100,000 up to which their savings are currently guaranteed at individual banks, if they distribute their savings across many banks. This is not only problematic from a distributional point of view, but it biases incentives away from holding bail-in instruments.

In addition, there are further concerns regarding the details, such as the negligible size of the SRF, the lack of a common backstop for it, and complex decision-making processes in bank resolution that require decisive and urgent action, to give a few examples. But these details camouflage a more substantial concern. Even if the Banking Union is completed, it does not do enough to remove the 'shadow/fiscal nexus'. A related concern is the threat that large banks pose to financial stability. Given large, complex and interconnected banks with business models reliant on market-based activities, including shadow banking, there might be impediments that make resolution appear risky. As indicated above, if bail-in instruments are held on the balance sheets of banks and some other types of financial institutions, vulnerability through interconnectedness might even increase.

4.3 Integration of public capital markets: European bonds

The Capital Markets Union (CMU) project launched by the European Commission intends to promote integrated private capital markets that should provide more diversified sources of financing for investment and herewith also help 'de-risk' the banking sector, that plays, according to the CMU architects, a too significant role in financing the real economy. Whether this project can deliver on its promises is open to debate. The endeavours to revive securitisation have astounded some commentators who fear that accelerating financial integration by further developing market-based activities and strengthening shadow bank entities and shadow bank activities of large banks might

increase financial instability and might even jeopardize the goal of de-risking banks (Gabor 2014).

Doubts about financial stability aside, at the current juncture it seems that the integration of public capital markets should be the top priority for promoting financial integration. The Five Presidents' Report sketches out the idea of a Euro Area treasury that could also issue Euro bonds with joint liability. However, Euro bonds are only foreseen after full fiscal integration. Given the reluctance to agree on Euro bonds, which involve risk-sharing among sovereigns and, hence, a true Fiscal Union, Brunnermeier et al. (2011) have proposed European Safe Bonds (ESBies). ESBies have the potential to alleviate the sovereign/bank nexus as well as the shadow/fiscal nexus und would herewith stabilise the Euro Area without involving risk-sharing among member states. This approach would further provide a highly liquid European low-risk asset. How does this work? An agency would purchase a certain share of public debt-to-GDP of each Euro Area member state. To finance this purchase, the agency issues a senior tranche and a junior tranche, e.g. in the relation of 70:30, as proposed by Brunnermeier et al. (2011). The senior tranche has a safe asset character; the investors are guaranteed the interest and principle payments should a member state default. Investors in the junior tranche who are willing to take on more risk in turn for higher yields have to accept a haircut if a country defaults. Risks of default are transferred to private investors and are not – as in the case of Euro bonds – a joint liability of member states. The ESBies proposal has been criticized for repeating the errors of the crisis by structuring a securitised product. But ESBies differ from the securitised financial instruments at the centre of the

financial crisis. They are high-quality non-opaque securitized assets because senior and junior tranches are underpinned by highly liquid, transparent government bonds, unlike illiquid, opaque mortgage or student credit as in the case of structured products.

4.4 Consistency of regulatory and governance reform

As argued above, the regulatory reform agenda and the Banking Union lack consistency in the way the problem of interconnectedness is tackled. The regulatory response to TBTF was initially addressed by raising the capital ratios imposed on systemically important banks, and later, by introducing a bank resolution framework.

Regulatory reforms including higher capital requirements have had an impact on the size of some large banks whose balance sheets have shrunk to some degree. Deleveraging was further sustained by the weak business environment. But imposing higher capital ratios on large banks might not protect them from failing in a system-wide stress, as argued by Blundell-Wignall et al. (2014, p. 71) when referring to the regulator's paradox *"that large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis.*" Interconnectivity, complexity and increased intermediation chains that are amplified by the derivatives portfolio make those banks highly vulnerable. Research has shown that trading on a large scale has destabilized banks. Trading also points to misallocation of capital, in part at the expense of lending (Boot and Ratnovsky 2012). From this research it follows that any

business model that combines core relationship operations with transactional activity on a large scale might no longer be sustainable.

Far-reaching regulatory reforms on resolution provided another powerful case for some kind of separation of a bank's high-risk activities, primarily proprietary trading, including trading derivatives, from its 'core' business, such as deposit-taking or retail payment services that are of vital importance for the real economy: TBTF banks that combine trading and core activities may be too large, too complex and too interconnected to resolve over a weekend.[2] In the US a weak form of intervention into the banking structure went into effect in 2014. The Volcker rule disallows short-term proprietary trading for banks' own accounts and restricts investment in hedge and private equity funds but it contains a number of exemptions. While in the US the principle of intervention was legislated early on, legislation on bank structure reform in the EU is still work in progress.

5. Conclusion

Governance reform is imperative for containing the centrifugal forces in the Euro Area. Completing the Banking Union is decisive to break the diabolic feedback loops between national banks and sovereigns, and much has been accomplished so far. Yet – as argued here – the focus on this nexus is probably too narrow. In addition, the 'shadow/fiscal nexus' amplifies the design failures of the Euro Area, and the Banking Union would do little to break this link. Since government bonds are the most important collateral

in market-based finance in Europe, their collateral value is inexorably linked to the pro-cyclical shadow-banking activities of large banks, which may trigger flight to safety and flows from the periphery to the core.

At least two considerations follow from this. First, introducing Euro bonds is one effective option to contain these destabilising forces together with those stemming from the bank/sovereign nexus, and they are a necessary part of a Banking Union. The ESBies proposal circumvents the political difficulties related to the various Euro bond proposals on the table that all involve some potential risk-sharing between member states that would, according to opponents, require a true Fiscal Union. ESBies work without mutualisation of debt. The risk of a default of a Euro Area member state is transferred to holders of the junior tranche of ESBies, who in turn receive higher yields.

Second, governance and regulatory reform lack some consistency. One may argue that the goals of a Banking Union, such as protecting tax-payers' money, may be jeopardized by reforms that further market-driven integration via shadow bank activities. By any measure, regulatory reform was far-reaching and ambitious, but it was partial too. Following stronger regulation of banks, risks migrated to shadow banking entities. The fundamental challenges posed by the architecture of European finance, which is shaped by large and systemically interconnected banks, have not been addressed sufficiently.

Notes

1. The views expressed are those of the author and do not necessarily reflect those of the National Bank of Austria (OeNB) or the Eurosystem. The author thanks Paul Ramskogler and Thomas Reininger for helpful comments.
2. In its opinion on the recommendations of the Liikanen report (2012), the EBA (2012) pointed out that in the absence of a legal segregation, as proposed by the High Level Group, "… *it might be extremely difficult for a supervisory authority to exercise its discretionary judgment and impose a break up of a universal bank,…*"

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Re-Booting Europe: What kind of Fiscal Union – What kind of Social Union?

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I. Introduction

There is a wide-spread attack on the single European currency, ranging from the rise of anti-European parties to Nobel Prize laureates such as Joseph Stiglitz (2016) with his claim that the Euro Area is an unsustainable currency union. Such criticisms are not new, having been raised by several American economists who predicted the Euro's failure from its very start.

While Stiglitz is right in criticizing many of the policy failures of European leaders during the sovereign debt crisis, his proposed solution of abandoning the single currency is not very helpful. Europe would have to go through a valley of tears, in precarious times, with quite uncertain outcomes.

Rather than engage in such scenarios, we will address in this paper both the challenges to the European Monetary Union (EMU) and the larger European Union, suggesting that the single currency is a European public good worth the political and intellectual effort to be 'rescued'.

Since the financial crisis, the EU has seen, due to the existence of an EMU, a very active monetary authority, and thus quite an independent central bank taking strong monetary and financial measures against the crisis.

The EU has also taken important institutional steps to reduce the so-called sovereign/bank nexus, and has completed two legs of the Banking Union with a European oversight function (the Single Supervisory Mechanism or SSM), and a common framework for winding up failing banks with a (currently underfunded) Single Resolution Fund (SRF). Missing is the third leg of a European Deposit Insurance (EDIS) which would provide risk-sharing across the euro-area banking system.

Many argue that the next building block should be to focus on the fiscal union and social union, in particular after Brexit, where a re-booting of the EU is important to improve fiscal and economic policy coordination and foster social cohesion in the Euro Area.

As for the Fiscal Union, one is tempted to compare EU fiscal institutions and fiscal policy to US fiscal federalism, but this is not an appropriate model. In the US, there are clear obligations and responsibilities with federal tax revenue expenditures historically shared between the federal state and the individual states. In addition, the monetary policy of the US Federal Reserve provides fiscal stabilization measures for the states in times of crisis. This type of

fiscal integration has not been reached in the EU and may be too ambitious.

As compared to the US, the EU member states have a long tradition of controlling their own fiscal decisions, manifested in national parliaments' power over taxes and expenditures against an Absolute State, monarch or ruling aristocracy. National sovereignty gave parliaments the power to make budgetary decisions on raising state revenues and expenditures, and issuing debts. Designing a workable European form of fiscal federalism thus means that national parliaments are likely to retain some sovereignty on tax, expenditure, and fiscal decisions. In other words, the challenge is how to obtain fiscal federalism within a loose fiscal union, where there is still a dominance of member states in economic, social and fiscal affairs (Semmler and Young 2016).

Given these specific conditions, any EU Fiscal Union is likely to work only if a two-track system is established where there is some form of federal treasury while, at the same time, sovereign national parliamentary decisions are preserved, or at least partially preserved. Going too far in one or the other direction would endanger the EU project as a whole. As a first step to creating full EU fiscal federalism with tax-and-spend powers, the art is to find a middle ground between federal fiscal institutions and preserving some national parliamentary budgetary decision-making.

In our contribution, we want to argue that fiscal stabilization policies should be planned at two levels—the central level dealing with aggregate macroeconomic instabilities, or instabilities arising from external effects at local or regional level, and in addition fiscal stabilization at member state level (i.e., national parliaments and ministries). This scenario

would embrace both fiscal consolidations as well as fiscal expansions during times of economic downturns.

This presupposes that central fiscal institutions are important. Richard Musgrave, who developed the path-breaking theory of modern fiscal federalism, identified in principle three important goals of the fiscal authorities: a) providing public goods, b) ensuring macroeconomic stabilization, and c) re-distributional measures counter-balancing market failures. The first function would provide fiscal capacity to fund European public goods so as to provide solutions to common problems that can no longer be resolved at local or national level. The second function of macroeconomic stabilization is based on Keynesian insights and complements the ECB in its monetary policy.

The final goal is re-distributionist policies that are supposed to correct market failures generating an uneven primary income distribution, an important pillar that was included in the post-war German social market. Until now, re-distributionist policies have been restricted to the domain of member state governments. In line with subsidiarity, these are primarily responsible for employment and social policies. However, after Brexit and the large populist revolt in many EU countries against free market policies and growing social inequality, it is in the EU's long-term interest to create more of a Social Europe.

Since the social policy agenda has been neglected in the EU, we will thus focus in the latter part of the paper on the social market economy tradition and ask whether the new Pillar of Social Rights introduced by the European Commission President, Jean-Claude Juncker in 2015 is the start of a European New Deal for a more socially cohesive

Europe. In other words, is there the prospect of a European social market economy that puts fundamental social rights above the freedom of untrammelled competition policy, providing hope for those who have been left behind in trying to cope with neoliberal market forces that have dominated the Single Market since its inception.

II. Major Recent Challenges

One also needs to think about the challenges facing the EU that need to be managed when it comes to fiscal institutions. The EU is a monetary (and incomplete banking) union, but not yet a fiscal union. There is a central monetary authority but a variety of fiscal policies/cultures. Undoubtedly, there have been some achievements since the start of the EMU but challenges remain.

1) Convergence/non-convergence

There was an initial convergence process in terms of human capital, infrastructure and productivity across countries (see Mongelli et al., 2015), but since the great recession starting in 2007/8 one can observe processes of divergence. Discussions centred on whether Germany created the imbalance and divergent trends by itself. In particular, the argument put forward suggests that the productivity of the German labour force grew faster than wages from the mid-1990s until 2007/8 and then started catching up again. On the other hand, nominal wages in some Southern countries moved

up more quickly (see the contributions of Herr, Janssen and Müller in this volume). For Germany, this created high current account surpluses and external imbalances in the Euro Area. There were also capital flows from the North to the South through the respective banking systems, with financial engineering taking place, by pushing credit into low-income segments of the population in the South (Kumhof et al., 2012). Although the chains of causality for the imbalances are unclear, imbalances and non-convergence or divergence have been distinctly obvious.

2) Fiscal Policy Failures

A particular driver of divergence has been the fiscal consolidation policy imposed on the South. There have been failures of fiscal consolidations since 2008/9. This has been recognized by official representatives of the IMF since 2013 (see Blanchard et al., 2013; also Semmler and Semmler, 2013; Semmler and Haider, 2017) as the perils of fiscal austerity during recessions. Important in this context are the new studies on the regime dependent multiplier. Evidence from non-linear VAR (MRVAR) is given in Mittnik and Semmler (2012). An IMF Study (Batini et al., 2013: 24) states: "In all countries a fiscal consolidation is substantially more contractionary if made during a recession than during an expansion" (see also Blanchard and Leigh, 2013). This has had adverse effects, since the fiscal austerity under pursuit has increased financial stress in all EU countries (see Schleer and Semmler, 2015).

3) Debt-deflation

What is more, there has been a trend toward debt-deflation in the South. Inflation rates were negative after 2008/9 and then again after 2014. With negative inflation rates, expenditure by households and firms declines, since the price of future goods is even lower, and agents postpone spending. This is the Tobin effect whereby an expected decline in prices slows down spending. On the other hand, with deflation, real interest rates rise and real debt increases (Fisher effect). Moreover, with deflation and low or negative growth rates, there is a rising insolvency risk among banks, since households and businesses cannot repay loans and risk premia for loans rise (Minsky effect) (Ernst et al., 2016).

4) Banking Vulnerability and Banking Union

Though a Banking Union has been put in place, numerous banking problems remain in the EU. Banks show rising debt levels since roughly 2000, actual bank debt has risen even higher since 2004 (see Schleer, Semmler and Illner, 2017). The Banking Union started with: 1) ECB supervision, 2) stress tests, 3) single resolution mechanism, and 4) the regulatory policy of bail-in (asset and bond holders of banks made liable in case of bank insolvency). Yet overall, bank vulnerabilities and perils (due to debt deflation, low interest rates inducing low spreads between long and short interest rates) remain, particularly in Italy.

5) Future sovereign debt

At the same time, we can expect at some point the ECB to gradually wind down unconventional monetary policy. The ending of Quantitative Easing (QE) and the Asset Purchasing Program (APP), possibly in 2017, will raise nominal interest rates and real rates might rise too if the inflation rate remains low. This is likely to recreate fiscal debt problems in the most fragile EMU member states, which will once more pose a crucial challenge for Euro-area stability – and create great perils for the Euro's continued existence.

6) Divergent political trends

Furthermore, there are/have been crucial elections in the Euro Area in 2017 (in the Netherlands, France and Germany) that may boost anti-European parties. These may mean further divergent trends in terms of EU fiscal policies, if politically populist/nationalistic governments come to power. The absence of or presence of merely weak social buffers in some countries will magnify this process.

In sum, the above challenges require careful consideration in terms of what can realistically be built, what type of interaction is needed between monetary and fiscal union/policies, and what proposals are necessary for fiscal arrangements and fiscal capacity building at federal EU level that, at the same time, accepts some kind of retained sovereignty by national fiscal authorities.

III. Stabilizing a Loose Fiscal Union

Current Institutions

The original construction under the Maastricht Treaty was a central monetary union and member states pursuing many different fiscal policies. The deficiencies of the Maastricht arrangements have received much attention in academia. We want to make only a few points:

- The ECB was given a mandate for price stability alone, with autonomy in pursuing this goal
- The Stability and Growth Pact relies solely on automatic stabilizers; national budgets should be balanced over the business cycle
- The Maastricht Treaty gives the Commission a strong mandate for conducting single market policies, favouring structural reforms but handing over no stabilization role.

Given these shortcomings, resulting in only limited room in the Euro Area for expansionary fiscal policy in recessions, it is not surprising that after the crisis of 2008/9, and the new challenges arising from Brexit and the election of Donald Trump as President of the United States, many politicians, academics and practitioners from industry, financial markets, and trade unions look to re-booting Europe, particularly on the fiscal front.

Need for broader fiscal tasks

As the many crises starting in areas of finance, banking and debt have demonstrated, local or national solutions are no

longer adequate for global and regional problems. There are eminent public goods problems which need a common solution at the federal EU level such as: investment in European infrastructure; European research and development tasks; policies concerning transportation, climate, energy, immigration and migration; internal and external security; and harmonization and standardization across product lines. Providing such funding would have the added value of contributing to cyclical stabilization across member states during times of recessions (Demertzis and Wolff, 2016).

Fair risk sharing needs new institutions

From the start of the EMU, there were two concepts as to how to balance the upcoming risks in a monetary union: one from Robert Mundell on the optimum currency area required high mobility of capital and labour, the other – adhered to also by McKinnon from the start in 2000 – is that a union will have lower capital costs and can be held together through risk-sharing. It has become apparent that the uneven performance of the European macroeconomy in the light of the many fiscal policies within a central monetary union is possibly generating greater risks and instabilities than foreseen. Given the current arrangements, and the above-mentioned possible phasing out of unconventional monetary policy in the near future, likely scenarios can be sketched out in a game theory set-up (see Canofari et al., 2016).

How is risk-sharing taking place to stabilize the Euro if there is a significant rise in sovereign debt and the risk of sovereign insolvency, as well as a threat to the Euro's

survival? There are two ways of responding and consolidating the public debt of member states:

- Non-cooperative game and indirect risk-sharing through debt reduction strategies, namely differential inflation rates – higher inflation rate in the North and lower in the South – and possibly Quantitative Easing (QE). The first one might be ambivalent, since higher inflation in the North through QE may reduce real interest rates there and raise them in the South, but deflation in the South – so some argue – may increase competitiveness and allow for debt repayment, though real interest rates may rise due to deflation. On the other hand, some QE reduces risk premia in the South and allows for easier borrowing and debt repayments. In addition, there would be a need for debt relief/restructuring through multiple escape routes, reducing perils for the Euro Area (see Semmler and Proano, 2015).
- Cooperative game and direct risk-sharing arrangements through cooperation and interaction of monetary and fiscal policy – with the goal of stabilizing the Euro Area through more highly coordinated fiscal policy, as well as monetary and fiscal policy cooperation to make debt sustainable. Low interest rates and QE and APP policies, for example, allow for relaxation in sovereign debt markets, low cost refinancing, and reducing sovereign default risk. As Canofari et al. (2016) argue, this might also allow the Southern countries to pursue an expansionary fiscal policy if required.

Whereas the first strategy needs less institution building but a higher adaptation cost due to sovereign default threats and the peril of the Euro Area falling apart, the second

requires more cooperation and institution building, and in particular this strategy would require extensive cooperation from Germany and other Northern countries. But, under the threat of the break-up of the Euro, the cooperative solution might be a preferable strategy.

Building fiscal capacity

Some experts argue that the plan of a Eurozone treasury seems premature because one needs first some fiscal capacity building, as Demertzis and Wolff (2016) suggest. They propose a sequence of three steps: First, completing the Banking Union, second, building fiscal capacity for the Eurozone in the area of public goods (dealing with environment/climate policy, migration, defence, fiscal stabilization), and building a social Europe (social security for buffering risk). And third, starting a fiscal federation by suggesting a centralized social security system with 20% of total government spending allocated to it.

Yet here, as with the widely discussed Eurozone treasury, unresolved issues remain such as the funding sources, checks and balances, as well as legitimization and accountability problems.

Moreover, additional EU emergency programmes are required. One could, for example, think of the Golden Rule of fiscal policy (see Saraceno, 2016 and Truger in this volume), where public investments are undertaken in a private-public partnership that issues development and green bonds that would, in turn, stem further divergence in growth and employment and promote convergence. This

is, however, designed to be a partnership where the public ensures itself a stake in its success.

Eurozone Treasury

The proposal for coordinated behaviour in the EU requires further institution building. Many scholars and practitioners have proposed a Eurozone treasury. In fact, both the presidents of the German and French Central Banks, Jens Weidmann and Francois Villeroy de Galhau, have suggested a Euro-treasury (Süddeutsche Zeitung 8.2.2017). They argue that the EU faces a stark choice: either more decentralization within the EMU and less solidarity, or a substantial reform of the EMU with the creation of a finance ministry, a more efficient and less fragmented European bureaucracy, as well as creating a stronger political board subject to parliamentary control. This would ensure the required balance between liability and control. (For further detailed discussion of a Eurozone treasury, see Semmler and Young, 2016).

The difficulty is how to achieve fiscal federalism in a loose fiscal union. Goals such as macro stabilization, public goods and redistribution should be pursued, but it is unclear which specified revenues, taxes and bond issuings should be assigned to the federal and member state levels – and how. The dominance of some member states over fiscal policy and their unwillingness to give up some sovereignty is a major obstacle that is hard to resolve. At the same time, monitoring the performance of member states' fiscal policy must be part of the design of a Eurozone treasury. Unresolved is also the

question about the democratic legitimacy and accountability of such an acting executive of a Eurozone treasury.

We will now turn to Musgrave's third pillar of correcting distortions in income distribution and analyse whether a Social Union is a feasible project for further EU integration. Can the idea of a European social market economy, mentioned as a specific goal in the Lisbon Treaty, provide a framework for combining policies promoting social protection and equality and those promoting market efficiency?

IV. The New EU Pillar of Social Rights of 2015

The European Commission has started to emphasize EMU's social dimension as a way to regaining some of the legitimacy the EU has lost since the financial and sovereign debt crises. Commission President, Jean-Claude Juncker, launched a new European Pillar of Social Rights on assuming office. He told the European Parliament that "I want Europe to be dedicated to being triple-A on social issues, as much as it is to being triple A in the financial and economic sense" (EU Press release, 22.6.2015). In spring 2016, the Commission launched a consultation paper on such a Pillar, which emphasized better functioning of labour markets and welfare systems as well as social cohesion as the core of the new process of "upward convergence" within the Euro Area. Other EU member states can join the Social Union if so desired at a subsequent time (European Commission 2016). In consultation with the other presidents of the EU institutions, the Commission will present a White Paper in 2017 and set completion of the EMU by 2025.

Many scholars agree that this new European Pillar of Social Rights is a step in the right direction, but the document (containing 34 social principles) is rather vague in terms of providing definitions of "adequate" income, "fairer EMU", "well-functioning and fair labour markets and welfare systems", and "reliable balance of rights and obligations between workers and employers". While it speaks about the role, scope and legal nature of the Pillar, it does not provide indicators to measure and compare member states' social performance and has little to say about compliance. Neither does it address the different legal competences between the EU and the member states, *inter alia*, on labour markets. For instance, Article 153 of the Treaty on the Functioning of the European Union (TFEU) clearly does not provide any Union competence in matters of "pay". It remains unclear how national and EU competences are to be shared in the Social Union (Sanden and Schlüter, 2016).

The Four Presidents' Report of 2012 (*Towards a Genuine Economic and Monetary Union)* and Five Presidents' Report from 2015 (*Completing Europe's Economic and Monetary Union*) already raise the prospect of a fiscal policy framework. Yet there is little mention of creating a discretionary fiscal policy or enabling an EU unemployment insurance[1] scheme as an automatic stabilizer to counter economic divergences across Eurozone countries since the financial crisis, or allowing permanent cross-border transfers. Experts have also criticized the fact that Jean-Claude Juncker has made no further reference to the Social Pillar since announcing it. This may indicate a divided Commission with strong internal opposition to establishing a Social Europe. There may also be strong headwinds on two further fronts: "The EU is

blocking social advances in certain areas at member states level and the member states are blocking social progress at European levels" (Höpner and Weiss, 2017, no page).

V. Social Europe Embedded within a European Social Market Economy

Creating new institutions for a socially fair Fiscal Union with a European treasury with its own budget, economic and tax coordination, and a common unemployment insurance scheme requires a comprehensive framework in the form of a European social market economy. This is not a new idea. Art. 3 of the Lisbon Treaty has already spelled out the goal of a social market economy, meaning that social concerns should be taken into account throughout the decision-making process. However, it did not provide details about the institutional structures required for a competitive social market economy. Building such structures at EU level is all the more difficult, since the social partners are not key players in this process. The Single European Act of 1986 and the Maastricht Treaty of 1992 were concerned with economic and monetary matters and left the social dimension to be dealt with at member state level. The major obstacle in EU social integration is the multi-layered institutional mismatch between EU market structures and nationally fragmented institutional arrangements. An added difficulty is the rise of virulent nationalism as witnessed in the form of Brexit and populism in many member states. As a result, national governments continue to insist that social and labour policies are "their" competences, demanding national priority over common EU solutions.

Given these national preferences, social policy has been a stepchild in European integration, creating a constitutional asymmetry between policies promoting market efficiencies and policies promoting social protection and equality (Scharpf, 2002). The European Court of Justice (ECJ) further sanctioned the subordination of social rights in the legal disputes between Viking, Laval, Rüffert and Commission versus Luxembourg. The ECJ ruled that freedom of competition took precedence over fundamental social rights. Its judgment meant that national social rights, such as the right to strike, make collective agreements or pursue wage policies were not allowed to interfere 'excessively' with the freedom of competition. In response, Mario Monti in 2010 warned that the subordination of social rights had the potential to alienate large portions of the workers' movement and trade unions from the European project (Bosch, 2017).

This alienation has become reality among the European populace, including many citizens bearing the brunt of austerity measures in the Southern periphery, and among members of the populist right-wing movements on the European continent. Yet a reform programme that would make monetary union sustainable and acceptable to ordinary people must be premised on the idea that the stability and integrity of financial markets, free trade, and free movement of labour depend upon a fairer balance between markets and social cohesion. Money and banking, trade, capital flows, movement of labour are not just technical issues reserved for experts, they also have important social, cultural and political dimensions and may have negative externalities across member state territorial boundaries.

A European social market economy?

Can the ideas of the social market economy offer some guidance on how to institutionalize a fairer compromise between competitive markets and social solidarity? The origins of the social market economy go back to the German economist Alfred Müller-Armack who coined the term *Soziale Marktwirtschaft* after World War II to rebuild with Ludwig Erhard (first as Economics Minister, and then as Chancellor) a warn-torn German economy. Müller-Armack belonged to a group of economists and lawyers in the 1930s, the so-called neoliberals, who opposed Anglo-Saxon laissez-faire liberalism and its notion of self-regulating markets. Rejecting the market fundamentalism that led to the Great Depression, post-war Germany faced the challenge of setting up a constitutional framework to establish both political and economic democracy within a federal system that did not rely on a strong centralized state. Business was free to operate within a market economy that was explicitly competitive. The social market economy also contained a major social element, since there were millions of refugees, war widows, orphans, war veterans, poor pensioners who could not be left exposed to market forces and had to be integrated into the new market economy. What matters most for our argument is that the social market economy was not the outcome of a strict technocratic ordo-liberal rules-based concept but rather of political leaders entering into concessions and compromises with existing socio-political forces.

Ludwig Erhard had to take into account the interests of the American occupation forces, demands of the Social Democrats and the impoverished working class, the war

destitute, West German big business, especially in the Ruhr region as well as the *mittelständische* firms of Southern Germany (Berghahn 2015). This pragmatism in creating a new federal economic system with weak centralization but a strong federal component institutionalized in the second chamber of the German Parliament (Bundesrat) may hold out some promise for building a European social market economy despite the fragmented and centrifugal tendencies among EU member states.

Of course, the ideas of Müller-Armack must be updated, they are overly normative and are a top-down paternalistic approach to achieving a balance between market freedom and social security. They must also be adopted to a Post-Westfalian (non-nation-state centered) political environment. However, his core concepts still hold today. Thus, the overriding essence of the social market economy for Müller-Armack is a "peace order" (Müller-Armack, 1972). Unlike his ordo-liberal colleagues of the Freiburg School, he insisted on a second pillar of social politics to the constitutional economic order. He defined social politics as an arena that should not be subordinated to economics in case of any conflict between economic and social concerns.

As early as the 1920s, Müller-Armack championed – before John Maynard Keynes – an active business cycle policy of state intervention. It is the duty of the state, he said, to ensure reconciliation between different interests. Müller-Armack goes beyond suggesting interventions in the economic order. For him, the social praxis implies shaping the entire scope of social life (Gesellschaftspolitik). Politics is thus not the result of a rules-oriented constitutional order, but is outcome-oriented and requires discretionary

intervention. Interpreting market failures as integral to free markets, Müller-Armack stipulated that since the constant adaptation of the market economy imposes high social hardships which individuals are forced to bear in their helpless and anonymous role, it is important to reduce justified and unjustified fears arising from the (otherwise unfettered) mechanism of free markets (cited in Vanberg, 2002; Lange-von Kulessa and Renner, 1998).

Understandably, given the compliance failure of the Stability and Growth Pact, the Maastricht Treaty, Two and Six Packs as well as the Fiscal Compact, some macroeconomists argue that fiscal capacities for countercyclical policies as advocated in the Five Presidents' Report are illusory at EMU level. Thus, fiscal policies are best left to the nation state (see Priewe in this volume).

However, it is not clear why social policies underpinned by unemployment insurance at EMU level fail as a regional public good benefitting the citizens of the member states. That social policies are prone to higher implementation problems, are more vulnerable to distributional conflicts and to moral hazard makes these policies no different from agricultural policies, nuclear, climate and energy policies, creating a Banking Union with a European Stability Mechanism as a redemption fund for banking liquidity crisis, or fighting terrorism.

In all these examples, collective tasks are resolved at the European level when they can no longer be resolved at the individual member state level. In other words, there is cooperation at the EU level to ensure that public goods are provided to all the citizenry. That in the process some national sovereignty is transferred to the EU level has been accepted as long as people feel it is in their common interest.

A Second Chamber for the European Union?

To make fiscal policy work at EMU level it may be more acceptable to include national parliaments in a hybrid decision-making process with the European Parliament. Again, this is not a new idea. Already the two EU Presidents' Reports of 2012 and 2015 have championed a hybrid model to increase legitimacy and accountability in cases of negotiating on politically fraught decisions. Again, little progress has been made on this front. A hybrid model may stipulate that fiscal decision-making will largely be made at federal EU level, but coordinated and controlled by national parliaments. Alternatively, as Bénassy-Quéré et al. (2016) suggest, national fiscal policies remain largely in nation state hands but decision-making over that policy is shared with the federal level. Such a hybrid model of power-sharing presupposes a new EU Parliament with two chambers.

This reform may be easier in the light of Brexit. The first chamber would comprise elected EU nationals and the second members of national parliaments and civil society. This would ensure that national parliaments and the voices of civil society are an intrinsic part of the EU fiscal decision-making process. Such an EU parliamentary reform should not be a top-down process. Instead, new innovative ideas should come from a European-wide competition conducted within a public assembly in which a broad spectrum of society are able to formulate ideas for such a hybrid model designed by the members of the EU for the members of EU.

VI. Conclusion

Doomsday scenarios about the survival of the Euro, and the EU itself have gained prominence since Brexit. The uncertainty has further increased since President Trump applauded the decision of the British people to leave the EU and expressed his open hostility to it. While we cannot deny the endogenous and exogenous challenges to the European Union, and especially to the European Monetary Union, these challenges can also function as an opportunity and incentive to think about how we can achieve a European social market economy that does not subordinate issues of fairness and equality to market competition. This was the intent of this paper.

In the first section, we enumerated the many challenges facing the EU that need to be taken into account when thinking about new fiscal institutions. EMU weaknesses became evident during the financial and subsequent sovereign debt crisis in the Eurozone. Since that financial turmoil, many institutional novelties have been implemented to stabilize the Eurozone. At the same time, the major challenge remains between a central monetary union and divergent fiscal policies in the member states. Originally, it was believed that a monetary union with an independent European Central Bank would eventually lead to a convergence of the various national fiscal policies. This is and remains the Achilles heel and biggest stumbling block in building a more integrated EMU.

Given the deficits in EMU institutional design, many experts believe that the next building block should be to focus on a Fiscal Union and Social Union to improve fiscal

and economic policy coordination and foster social cohesion in the Euro Area. The next section of the paper discussed the institutional requirements for fiscal capacity building and the introduction of a Eurozone treasury. In the final section, the focus shifted to the ideas of a European social market economy and argued that a modernized version of the original concept of the German social market economy, as initiated by the economist Alfred Müller-Armack, may function as a starting point to ensure a fairer balance between markets and social cohesion. Social policy for Müller-Armack is a "peace order" and, unlike his ordo-liberal colleagues of the Freiburg School, he insisted on discretionary intervention to reduce justified and unjustified fears among people arising from market failures.

In contrast to other scholars, we argue that fiscal policy capacity building should be both at the federal EU level with input and control from national parliaments. Such a hybrid model of power-sharing assumes a parliamentary structure with two chambers. The first chamber would comprise the citizens of the EU, and the second representatives of national parliaments and civil society.

Creating a Fiscal Union and Social Union should not be a top-down project from European experts and economists. Instead, there should be citizen involvement in the form of a public assembly (including activists, entrepreneurs, political leaders, economists, business managers) to design and create such a new hybrid institutional structures for a digitalized 21st century.

Notes

1. A good beginning for an EU unemployment insurance has been made by an EU Commission document (EU Commission 2016) and Dullien (2014) who suggests a two-pillar system: A minimum EU unemployment insurance (50 %, 1 year), topped up by national unemployment insurance (60 % and of longer duration).

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The golden rule of public investment as a lowest common denominator to achieve a fiscal stimulus in the Euro area*

Achim Truger

1. Introduction

It is crystal clear that the Euro area's institutional architecture will have to undergo far-reaching reforms if the Euro is to be saved and prosperity restored. This is rightly highlighted in many articles in this volume. It is completely unclear, however, how the necessary changes are to come about politically. For many years, political conflicts driven or at least exacerbated by conflicting economic world views have prevailed. Whereas Keynesian or undogmatic mainstream economists and politicians in the periphery call for

* Sections 2 and 3 of this paper are based on an updated, modified and shortened version of Truger (2016a) which in turn borrowed from Truger (2016b) albeit with substantial revisions and updates. Section 5 is based on chapter 3.2 of Timbeau et al. (2016).

an end to austerity policies, more fiscal flexibility and a partial mutualisation of member states' public debt, some economists, lawyers with little understanding of macroeconomics and politicians in some of the core countries and, in particular, in the German finance ministry call for a continuation of austerity and even tighter fiscal rules. This stalemate renders the economic recovery weak and fragile. Given the lack of political will in the face of the coming political challenges, this means that the whole Euro project may collapse sooner rather than later.

What is required, therefore, is a politically feasible short-term strategy to save the Euro. Such a strategy must bring about a substantial fiscal stimulus for a strong and sustained recovery in the Euro area. This would help stabilise the social and political situation in the member countries, buying time for initiating the necessary institutional reforms in the medium term. In the current stalemate the strategy would have to be based on a lowest common denominator that all different parties could agree on. This article argues that one potentially promising candidate for such a common denominator could be the traditional Golden Rule of public investment as it can be supported by economists from many different theoretical schools. If pragmatic recourse to the Golden Rule could push politicians into successfully boosting public investment and reinforce the recovery then this could conceivably initiate a political learning process that might in the end achieve the necessary more ambitious institutional reforms in the long run.

Section 2 introduces the basic idea of the Golden rule of public investment and addresses the problem of different definitions of public investment. Section 3 shows that

traditional public investment as defined in the national accounts is a potent tool to boost economic growth both in the short and long run. Section 4 explains why a very pragmatic approach to defining public investment may both be economically sensible while at the same time increasing political feasibility. Section 5 then turns to the question of approximating the golden investment rule even within current European institutional constraints on fiscal policy. Section 6 briefly gives an outlook whether the proposal is realistic in the current political circumstances.

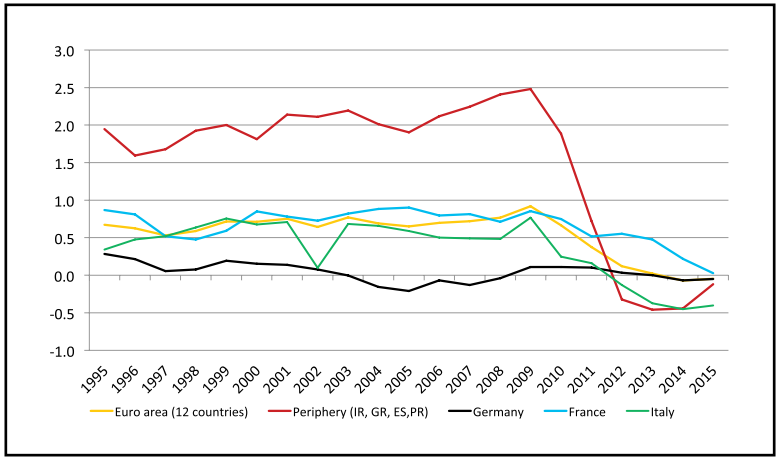
2. The Golden rule of public investment: From theory to operationalization

2.1. The pay-as-you-use-principle and intergenerational equity

The golden rule has been a widely accepted traditional public finance concept for the handling of government deficits for decades (see Musgrave 1939 and 1959: 556-575). It strives for an intertemporal realization of the pay-as-you-use principle in the sense that present government spending provides future benefits. It calls for financing such spending (=net public investment) by government deficits, thus promoting intergenerational equity. Net public investment increases the public and/or social capital stock and provides benefits for future generations. Therefore, it is justifiable that future generations should contribute to financing those investments via the debt service. Future generations inherit the burden of public debt, but in exchange they receive a corresponding public and/or social capital stock. Failure to allow

for debt financing of future generations' benefits will lead to a disproportionate burden on the present generation through higher taxes or lower spending, creating incentives for the under-provision of public investment to the detriment of future generations. This general incentive problem may become exacerbated in times of fiscal consolidation when cutting public investment may seem the politically easiest way to reduce the budget deficit. The development of net public investment, i.e. gross investment minus depreciation in the Euro area, shows that this danger is real and has, in fact, materialised in the most striking manner: net public investment in the Eurozone periphery, with its particular need for a catch-up in infrastructure, has decreased from about 2 per cent of GDP to a negative -0.6 per cent – the net public capital stock was thereby shrinking. For the euro area as a whole and for Germany in particular net public investment has been negative since 2013 (see figure 1). Independent of the current crisis, there is evidence that fiscal contractions were a key factor responsible for the decline in public investment in earlier decades (Välilä et al. 2005; Turrini 2004: 9-26).

Figure 1: General government net fixed capital formation (ESA 2010) in the euro area, the European Periphery and selected countries in per cent of GDP, 1995-2015



Source: European Commission (2016); author's calculations.

The concept of the Golden Rule has many prominent advocates in academia starting with Richard A. Musgrave, one of the founding fathers of modern public finance. In the context of the fiscal policy debate in the EU, many economists have criticised the EU Stability and Growth Pact (SGP) for its lack of a Golden Rule on public investment and correspondingly proposed to introduce such a rule into the fiscal framework (e.g. Fitoussi and Creel 2002: 63-65, Blanchard and Giavazzi 2004, Barbiero and Darvas 2014). Last but not least, the German council of economic experts delivered a proposal which explicitly expressed the need to include the Golden Rule as an important element of its concept for a constitutional

limit to government deficits (SVR 2007). Ironically, this proposal became the blueprint for the German debt brake as well as the Fiscal Compact, but unfortunately with the Golden Rule itself removed.

2.2. Different definitions of public investment

Although the general idea behind the Golden Rule is plausible and easy to understand, its operationalization is not trivial. The most difficult problem is to find a workable and economically sensible definition of the term 'public investment' that allows for government deficits. Theoretically, any government action that creates benefits – in the widest sense – for more than one period may qualify for this. However, the literature usually focusses on concrete future material economic benefits in terms of higher productivity and growth. Therefore, the central question at a macroeconomic level is whether general categories of public spending can be identified that are usually associated with sufficiently higher growth and productivity.

The natural candidate for such a definition would be the traditional concept of investment in the national accounts (see section 3 below). However, there may be other expenditure categories that may be equally or even more beneficial. A prominent example would be public spending on education or health care which in the existing system of national accounts is classified as current expenditure. Education as investment in human capital is crucial from the point of view of endogenous growth theory (Lucas 1988) and empirical research suggests that the private as

well as social rate of return of education can be assumed to be very high (Psacharopoulos and Patrinos 2004; Card 2001). Although it is difficult to compare the estimated rate of return for different types of expenditure reliably, it would at least be plausible to include public education expenditures under the Golden Rule. This is also the general conclusion drawn by most of its advocates.

At the present stage, it may be difficult to implement this in a convincing way. First, an exact definition of the relevant education expenditure would have to be given which is not straightforward. Second, in order to be consistent with the Golden Rule, net education investment would have to be measured, i.e. depreciation would have to be deducted. This may pose some difficult conceptual issues that would have to be resolved before education expenditure could be properly included into the Golden Rule.

There are still more expenditure categories that might be considered as investment under the Golden Rule. Indeed, from a supply-side perspective some types of social spending may well be highly productive, because they increase labour supply and production: Health expenditures, if effective, will contribute to a more stable and larger workforce. Spending on child care can substantially increase parents' labour force participation (Bauernschuster and Schlotter 2015). And the same may be said for spending on social work and integration. All of this could lead to higher labour force participation and therefore contribute to higher growth and, at the same time, to one of the main "Europe 2020" goals. Obviously, it is not easy to find adequate definitions and estimating depreciation in order to derive net investment may be even more difficult.

3. Growth effects of traditional public investment

The central question of the long-run growth effects of public investment has received much attention in the literature (for an overview see Romp and de Haan 2005; Melo et al. 2013; Bom and Ligthart 2014). From a theoretical point of view, it is most plausible that public investment, especially if it focusses on "core" infrastructure like transport facilities (roads, railways, ports, airports), communication systems as well as power generation and other utilities should be productive and growth enhancing. The public infrastructure stock in this sense is simply indispensable for most production processes. It is, therefore, plausible to think of public infrastructure as an input factor that is complementary to private capital and labour, inducing additional private investment and labour supply. Net public investment need not necessarily go into completely new infrastructure projects: Given the fact that the quality of the existing infrastructure stock may have decreased through wear-and-tear, (IMF 2014: 79-81) maintenance investment may also have an important role to play.

Empirically, the effects are contested in the literature. The famous study by Aschauer (1989), using a production function approach, found a very high elasticity of output with respect to the public capital stock. This would have meant an extremely high return on public investment, indeed, much higher than imaginable for private investment. In the debate that followed, many different definitions of public (infrastructure) capital were used, different estimation techniques and variations on Aschauer's original approach were introduced. Furthermore, apart from Aschauer's

original production function approach, the cost-function approach, times series analysis as well as cross section estimations were also applied. Although the results differed greatly and some studies found no or even negative effects of public investment on growth, the general conclusion is that there is a positive growth effect, but that it is much smaller than originally claimed by Aschauer (see Romp and de Haan 2005; Melo et al. 2013).

Table 1: Implied marginal returns to public investment in per cent.

	all public capital		core public capital	
	Regional	national	regional	national
short term	17.4	10.2	24.0	16.8
long term	28.0	20.8	34.6	27.4

Source: IMF (2014: 86); Bom and Ligthart (2014: 907-908); author's calculations.

Bom and Ligthart (2014) conducted meta-regressions including 68 studies with 578 estimates for the public capital-growth nexus and confirm this basic conclusion for the period 1983 to 2008. According to their results, the average output elasticity of public capital is 0.082. Conditional elasticities vary depending on whether they refer to the short or the long run, to all public capital or core infrastructure and to regional or national investment. They are higher for core infrastructure, for regional investment and for the long run. Table 3 shows the implied marginal

returns which are in the range between 10 per cent (short run, national, all public capital) and 34.6 per cent (long run, regional, core infrastructure). Whereas the latter marginal return is large enough to justify deficit-financed public investment, even under pessimistic assumptions about the user cost of capital (real interest rate plus depreciation rate), the former would have to rely on more favourable conditions. However, the implied long term marginal returns even in the case of all public capital for national and regional investment with 20.8 and 28 per cent respectively are quite high. All in all, therefore, one may safely assume traditional public investment to have substantial pro-growth effects.

In addition to the long-run supply-side effects, the short-run demand-side effects of public investment must also be addressed. The traditional pre-crisis empirical studies usually found substantially positive multipliers. As suggested by the standard Keynesian textbook models and the Haavelmo-Theorem, expenditure multipliers were typically substantially larger than revenue side ones (see e.g. the overviews by Hemming et al. 2002, Bouthevillain et al. 2009). Many of the more recent studies confirm the earlier multiplier estimates and in many cases even go substantially beyond them (Gechert 2015 and Gechert and Rannenberg 2014). As to the question of the relative size of the public investment multiplier, the pre-crisis literature as a rule of thumb found it to be (slightly) above one and therefore slightly larger than for other spending categories so that public investment, in addition to its long-term economic advantages, could be seen as the most effective short-run fiscal policy instrument. Some of the recent studies even come up with much larger (relative) estimates of the investment multiplier. Auerbach and Gorodnichenko

(2012) obtain values larger than two with a maximum estimate of more than four whereas the estimates for government consumption spending are "only" at about 1.4. Gechert (2015) and Gechert and Rannenberg (2014) conducted meta-regressions including 104/ 98 empirical multiplier studies controlling for different study characteristics. They also find generally higher investment multipliers as compared to their consumption counterparts (around 1.6 vs. 1), but the difference is certainly not as large as in the Auerbach and Gorodnichenko (2012) paper. On average, Gechert (2015) and Gechert and Rannenberg (2014) find systematically smallermultipliers for government transfers. All in all, therefore, the empirical literature on short-run effects of fiscal policy strongly supports protecting public investment from consolidation pressures and using it to stimulate the economy.

4. Towards a pragmatic definition of public investment

As shown in section 2.2, from an economic point of view there are different definitions of public investment that could be considered within the logic of the Golden Rule. Politically, this ambivalence can be disastrous in the sense that different actors may prefer different definitions and this will undermine political consensus in favour of the Golden Rule. For example, conservatives will tend to prefer the traditional definition from the national accounts. Liberals and progressives may tend to prefer a definition including spending on education whereas Greens will tend to favour green investment over traditional investment. Politicians with a focus on social policy will favour a definition including at

least parts of social spending. Finally, deficit hawks will tend to be suspicious of any privileges for specific expenditure categories as they fear the Golden Rule will simply be used to undermine the deficit limits of the SGP.

How does one resolve the controversy? First, to convince people concerned about risks for the sustainability of public finances, one could offer to limit the maximum amount of net investment to be considered under the Golden Rule to 1 or 1.5 per cent of GDP. Second, the solution proposed here advocates a very high degree of pragmatism in the definition of public investment. This plea for pragmatism is based on the conviction that an investment-related fiscal boost is so important in the current situation that neither the exact definition nor the exact procedure as to how the definition is arrived at should dominate the debate and the final decision. In short: Protagonists of the Golden Rule logic should agree on whatever definition or procedure is most likely to find a political majority.

As to the procedure, one may try to reach political agreement directly or one may delegate it to a scientific and/or political committee. One may leave it to the European Commission and the Council to take the final decision. One may also suggest that the Commission and Council use changing definitions according to the most important political priorities. This could e.g. also be investment in education, including child care, or it could more generally focus on spending with a view to achieving the currently neglected Europe 2020 goals such as social inclusion or other areas that have strongly suffered from austerity in recent years and then move on to more traditional investment definitions in future.

But why should proponents of a particular definition agree with a different definition? The reason is that – as long as economically sensible expenditure is characterised as investment – the Golden Rule will directly and/or indirectly create fiscal leeway even for those expenditure categories not directly privileged under it: To the extent that there is already positive net investment with respect to the chosen definition the golden rule directly creates the corresponding leeway for other purposes. Furthermore, it should be noted that through its partly self-financing nature the golden rule creates additional fiscal leeway that can be used for other purposes. The fiscal stimulus leads to a higher GDP which will in turn lead to an improvement in the budget balance. Whether this improvement opens up additional fiscal leeway depends on whether it is interpreted as cyclical or as structural. According to the *de facto* pro-cyclical method of cyclical adjustment by the European Commission (Truger 2015b and 2015c), a substantial part of the improvement would be interpreted as structural, so that it could be used for further fiscal stimulus. This in turn starts an additional expansionary process (Truger 2016a).

That way the definition of government investment to be included in the Golden Rule becomes less crucial. Even if one has serious doubts about the rather narrow definition of public investment based on the national accounts – that might be preferred for pragmatic reasons in the political process – the endogenous creation of further structural fiscal leeway will allow a strong increase also in those parts of government expenditure that are not directly privileged by the narrower definition of the Golden Rule. Plausible, multiplier-based simulations (Truger 2016a) suggest that

the indirect leeway created could be almost as large as the initial investment stimulus allowed under the Golden Rule.

5. Implementing a public investment stimulus within the current European fiscal framework

For a regular implementation of the Golden Rule within the fiscal framework of the SGP and the fiscal compact, net public investment suitably defined would have to be deducted from member states' relevant deficit measures, i.e. from the government deficit under the corrective arm and the structural deficit under the preventive arm of both pact and compact. In effect, this means that the threshold for an excessive deficit as well as the medium-term budgetary objective would be increased by the amount of net public investment. However, such an implementation would most probably need a change of Council regulations or even the Treaty as the Golden Rule would permanently change the interpretation of the relevant deficit definitions in a way that is not completely in line with the Treaty.

Obviously, this poses an impediment for immediate implementation, even if the necessary changes could be adopted as primary law in the form of an 'Investment Protocol' that would be annexed to the Treaty under the simplified revisions procedure of Art.48 of the Lisbon treaty (see table 2). At member state level, further legal changes would be required if following the fiscal compact as there were other legal provisions put in place that would prevent a deduction of net public investment from the budget balance.

Table 2: Various opportunities to strengthen public investment and facilitate an expansionary overall fiscal policy stance in Europe

Goals	Measures
short term (use interpretational leeway within present framework to increase budgetary flexibility and boost public investment)	
strengthening investment + expansionary overall fiscal policy stance	(1) allow for temporary investment programmes (analogous to the European Fund for Strategic Investment)
	(2) interpret emporary investment programmes as structural reforms
	(3) incorporate realistic investment multiplier in budgetary analysis ex ante
	(4) increase flexibility for cyclical conditions
	(5) use exception for severe downturn
	(6) implement better methods of cyclical adjustment
medium term (solid implementation of changes regarding public investment)	
EU implementation	(7) 'investment protocol' as annex to the Treaty (simplified revisions procedure Art. 48)
national implementation	(8) change national legislation to allow necessary changes based on the Golden Rule of public investment combined with a better spending rule

Source: Timbeau (2016: 120).

It is indeed possible to use the leeway inherent in the current institutional framework for such a stimulus provided the Commission and Council prove willing to more actively use the interpretational leeway within this framework (see Table 2 for an overview of measures). In fact, the clarification as to the interpretation of the Pact that the Commission (2015) has given as well as the end-point of the Commonly agreed position on Flexibility in the Stability and Growth Pact by the Council can already be seen as illustrating important if still timid steps in that direction.

At least additional net investment could be justified if it came in the form of a temporary investment programme, analogous to the way the Commission interprets contributions to the EFSI (1 in table 2, same for the following numbers). Additionally or alternatively, it may be possible to treat an investment programme as a structural reform that temporarily allows for deviations from Medium Term Objectives (MTO) or the adjustment path towards it (2). Admittedly, the conditionalities and limits set by Commission and Council in their current interpretation (co-financing of EU projects, limit of 0.5 % of GDP which is an arbitrary margin, mostly for countries in the preventive arm) certainly block a substantial and sustained fiscal stimulus, but at least the provisions may be used for some stimulus and political pressure may be built up to push for a more generous interpretation in application or for a more generous official reinterpretation.

Reference to adverse cyclical conditions might help to increase leeway even further (4), although this could create the danger of a stop-go investment policy, if cyclical conditions improve as can be expected under an investment programme. Probably the most convincing way to increase member states' fiscal space in the short run would be to use the provision concerning a severe downturn in the Euro area or the EU to justify a temporary deviation from the consolidation path, thus allowing for a substantial European Investment Programme. The Commission has made an explicit comparison with the 2008 European Economic Recovery Plan (European Commission 2008) to give a conditional example of the potential use of this provision: it "should remain limited to exceptional, carefully circum-

scribed situations to minimise the risk of moral hazard." (European Commission 2015: 17). In fact, one may well argue that the Euro area is still in such an exceptional situation after years of recession, stagnation and low inflation while monetary policy is at the lower bound.

All of this could further be supported if realistically high multiplier values were used in assessing the budgetary impact of additional investment which may not be significantly negative or even positive (3). Reconsideration of the Commission's method of cyclical adjustment (6) – e.g. to be more in line with the OECD method and results – may create further leeway as it might increase the cyclical part of the budget deficit, thus reducing the structural deficit (Truger 2015b). In fact, one may well argue that the negative output gap calculated by the Commission underestimates the bad cyclical condition of the Euro area economy by as much as 4.3 percentage points (Jarocinski and Lenza 2016) in 2015. Applying standard budgetary semi-elasticity, this would first of all substantially change the structural balance calculations by about 2.2 percentage points, creating substantial leeway for the countries under the preventive arm of the SGP. As fiscal effort calculations would also be affected positively this would also help countries under the excessive deficit procedure. Finally, the dramatically more negative cyclical condition would create more leeway to use the exceptional clause under the Excessive Deficit Procedure.

Using some of these measures, it should be possible to implement a fiscal stimulus programme for public investment in the definition deemed necessary in the dimension of 1-2 % of GDP for several years.

6. Outlook: Can there be a minimum consensus?

Most parts of the euro area have seen eight years of deep economic crisis. Despite all efforts by the European Commission and the ECB growth prospects have not improved substantially since mid-2014. Obviously, a change in macroeconomic policy strategy is needed. Reform proposals that require thorough institutional changes – although clearly necessary in the medium term – are far too ambitious in the current political situation. Therefore, this article has proposed an extremely pragmatic short-term strategy to improve growth and employment and thereby contribute to saving the Euro system. Using the arguments from the Golden Rule of public investment as a lowest common denominator, fiscal policy is to boost public investment in whatever suitable pragmatic definition in order to support the recovery and buy time for the more ambitious medium-term institutional reforms.

But will even such a small-scale pragmatic solution be politically feasible in the current situation in the Euro area? This is difficult to predict. In principle, promoting some deficit-financed public investment should hardly be impossible given that the Golden Rule arguments stem from traditional public finance. However, even the minimum consensus necessary for such a pragmatic approach may not exist now: The German finance ministry even refuses to boost public investment despite structural budget surpluses, despite large needs for infrastructure (maintenance) and even though there is evidence that the additional investment could be fully self-financing, and this in a macroeconomic constellation where Germany spends 9 per cent less than it produces. No wonder

that neighbouring countries blame Germany harshly for its fiscal policy stance. If this kind of deep disagreement about basic macroeconomic questions on the part of key political players persists, the Euro will most probably be doomed.

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Re-balancing macroeconomic imbalances

Macroeconomic Imbalances in Europe: a mistaken concept?

Stefan Collignon

In 2011, European authorities introduced the macroeconomic imbalance procedure (MIP) in response to the Euro crisis. It aims to identify, prevent and address the emergence of potentially harmful macroeconomic imbalances that could adversely affect economic stability in member states and in the Euro Area as a whole. Yet, because the procedure focuses largely, although not exclusively, on reducing current account deficits, it has become a major argument for justifying excessive austerity policies in Europe, and it has negatively affected social stability.

The new MIP instrument was inspired by the excessive deficit procedure that frames the Stability and Growth Pact (SGP) for fiscal policy. The European Commission produces every year an alert mechanism report (AMR), which analyses the economies of all EU countries. Countries whose situation requires deeper analysis are then subjected to an in-depth review (IDR) and, if they are considered to have excessive imbalances, they will receive policy recommendations for reducing them[1].

When the Maastricht Treaty was negotiated, current account positions were never discussed as a significant policy indicator. The prevailing view was, as Ingram (1973, p. 10) put it long before: "Intracommunity payments become analogous to interregional payments within a single country". Blanchard and Giavazzi (2002, p. 148) looked at rising current account deficits in Greece and Portugal in the early years of Monetary Union (MU) and found: "They are exactly what theory suggests can and should happen when countries become more closely linked in goods and financial markets".

All this changed during the Euro Crisis when a new revisionist literature emerged. It was observed that all crisis countries in the South had run very large current account deficits, which were explained by large budget deficits in Greece and Portugal and by excess investment in real estate in Ireland and Spain. This literature argued that the euro had been badly constructed, because it had ignored the current account positions of member states. For example, Holinski et al. (2010, p. 10) claimed that the persistent trade deficits in the South feed the accumulation of foreign debt and "this process is unsustainable and will eventually lead to exploding foreign debt levels". The European Commission soon adopted this view and invented the MIP.

However, as every economics student learns in her/his first year, correlations are not causes. The correlation between current account deficits and the crisis does not explain what caused the crisis. The MIP commits the logical fallacy of treating regional imbalances between member states of the Monetary Union as if they were caused by payments between foreign countries with foreign currencies. It reduces macroeconomic policy objectives narrowly to only one variable, when

in fact a broader and more integrative approach is need. While it is certainly useful to prevent excessive imbalances in a broad sense, one must question whether the way the new procedure is applied has not been doing more harm than good.

The foreign country fallacy

In countries with different currencies, monitoring current accounts is a reasonable policy approach. They indicate the net borrowing (if negative) or net lending *of foreign currency*. Excessive deficits lead to the loss of foreign exchange reserves, the weakening of the exchange rate and could ultimately necessitate a default on debt denominated in foreign currency. This has often happened in Latin America. Within the European single market, this would be highly disruptive and would warrant a procedure that ensures the stability of exchange rates between the Euro and currencies of EU member states outside the Euro Area.

However, within the Euro Area, the economic reality is very different. Payments within the Union, say between Greece and Germany, are not made in foreign currency, however estranged the citizens of the two countries may seem, but in domestic currency. Payments are made in Euros by firms, households and governments. These economic actors obtain their Euros by using previously saved cash, or by borrowing from banks or financial markets. Ultimately, all Euros come from the European Central Bank. The ECB regulates the aggregate money supply in accordance with its mandate to preserve price stability, and the banking system distributes these Euros across the Monetary Union. There

may be problems in the smoothness of this distribution due to the insufficient degree of Banking Union, but this does not invalidate the functioning of the system.

It follows that, say, when a Greek taxi driver wants to buy a German car, he borrows from a Greek bank or a German leasing company and these financial institutions obtain the (base) money necessary for making the loan from the ECB.[2] There is no need to exchange Greek against German currency at a "permanently fixed exchange rate", nor does anyone need to earn "German Euros",[3] because national currencies do not exist. Euros in Greece and Euros in Germany are the same domestic currency. A loan in Greece may be financed by the Greek banking system borrowing from the ECB, in which case it increases the money supply in the Euro Area, or by borrowing Euros held by, say, a German bank, in which case the money supply in the Euro Area remains stable. However, in both cases the stock of money (a liability) increases in Greece, although in the second case the stock of money diminishes while financial wealth claims increase in Germany. Yet, our taxi driver needs to repay the loan; he must balance his increased liabilities in Greece by higher real assets, and this means he needs higher income. In aggregate, economic growth is required to service all outstanding debt.

This is where the difference between multiple currency areas and monetary union becomes clear. An importer in Poland needs Euros to pay for German cars, which implies that she/he would have to change Zlotys against Euros. Some agents in the Euro Area must wish to obtain Polish currency to make payments in Poland. The ECB does not supply Euros to Poland; these will become available in Poland when Polish exports into the Euro Area generate

income in Euros or European investors lend money to Polish borrowers (capital imports). Polish importers will then be able to use these Euros to make payments to their suppliers or to service foreign debt (capital outflows). The aggregate of these reciprocal movements between Polish demand for foreign currency and foreign demand for Zlotys is recorded in the balance of payments. A deficit in the current account position means Poland is borrowing foreign currency from the rest of the world in order to pay for an excess of imports, which means in aggregate the country is building up a net debtor position that needs to be paid back in time. The only way to sustain foreign debt and guarantee its repayment is, therefore, to turn the current account balance into surplus – unless there is a sustained inflow of Foreign Direct Investment (FDI) and similar non-debt capital.

By contrast, in the Euro Area, the economic mechanism is similar to a sovereign country, which has its own currency. Trade deficits between member states are *regional* imbalances, because all payments are made in domestic currency. A currency union is first of all a payment union, because money is a means of payment. Take our Greek taxis driver who needs to pay back his loan. He must make a profit and earn Euros by selling his services, so that he is able to service the debt. But he does not need tourists bringing in Euros from Germany (although he may appreciate this source of profit). Even if he had only local people as customers, he can pay his bank in the domestic currency, in Euros. His higher income will be a source of funds. This implies that he increases the asset side in his balance sheet and this will match the liabilities, which are growing because he has to service his debt. He can of course repay his bank loan,

which would shrink his own and the bank's balance sheet, so that money supply (the level of bank deposits) will fall in the Euro Area as a whole. On the other hand, if he has borrowed from a German bank, the repayment reduces the stock of financial claims in Germany and replaces them with cash, which is a liability of the Central Bank; as a consequence, money supply in Greece is down and in Germany up, but overall money supply in the Euro Area remains constant. Clearly, this situation is sustainable as long as the growth of income is sufficient to cover the interest on outstanding debt, because the balance sheet remains *solvent*.

Thus, in the aggregate of the Greek economy, there is no need for Greek current accounts to be in balance or surplus, because in Monetary Union, the counterpart of the apparent current account deficits is an automatic money flow either through the banking system *or through the creation of money by the central bank*. There is no "foreign" debt that needs to be serviced by net exports in the tradable sector. What is needed, however, is that *aggregate income* increases sufficiently for Greek debt to be serviced. In other words, Greece needs economic growth, and it does not matter whether this growth is generated by exports or by domestic demand.

This condition of sustainable equilibrium is often written $y \geq r$, where y stands for the growth rate and r for the interest rate. If this condition is not met, the dynamics of debt, whether private or public and whether individual or aggregate, requires additional funds; otherwise the debtor will have to default. For example, if this condition is not met for government, it must generate a primary budget surplus (i.e. tax income minus spending) that is sufficient to sustain the debt.[4] This may require austerity measures, say, by

reducing public consumption, but the important point is that such adjustment does not *necessarily* involve balanced current accounts. I shall come back to this in the next section.

There remains the danger of liquidity crises. As long as Greek banks have access to liquidity from the ECB, they are able to provide the funds for making payments. This is the fundamental difference to a multi-currency system, because the definition of a currency union is that all banks in the area have unlimited access to the so-called discount window of the central bank. If this window is closed, a country is effectively expelled from the Monetary Union. This would be a political decision of constitutional quality and is not subject to the European Central Bank's discretion. Greece and Cyprus came very close to such a situation, but the system was sustained by the special emergency liquidity assistance (ELA) facility. The problem is the insufficient degree of integration of the European banking system. In an ideal world, banks would have highly diversified client portfolios, which ensure that the default of one debtor can be absorbed by the profits from other clients. However, European banks have significant "home biases", which means they lend more to local companies and governments than to the rest of the Euro Area. Now, if a particular region, say Greece or Spain, is affected by a negative shock, which pushes these local clients into defaults and/or liquidation, the profitability of local banks can be seriously impaired. Investors may then shift their assets into safer institutions and regions. Such capital flight can lead to the collapse of regional asset prices, which will then seriously handicap regional growth conditions. This dynamics has been one of the major drivers behind the Euro crisis (Collignon, Esposito, & Lierse, 2013). In order to make the European Monetary Union robust, the European

Banking Union needs to be completed with a collective deposit insurance system (Gros, 2015).

The austerity trap

The focus on current account imbalances is therefore a mistake. The consequences are dire. If the policy prescription is to reduce the current account deficit, the only way to do so is austerity. We know from national income identities that the current account balance (CA) is the sum of the savings-investment balance (S-I) and the government budget position (T-G):

$$(1) \qquad CA = (S - I) + (T - G)$$

S stands here for household savings, I for investment, T for tax income, and G for government spending. Hence, reducing a current account deficit requires raising the savings rate or lowering investment or increasing taxes and lowering government spending. Now, each of these policy variables may be useful to achieve particular policy objectives, but the requirement to balance the current account position for each member state in the monetary union is counterproductive, because it ignores the interdependencies in the payment union and may therefore generate a violation of the equilibrium condition $y \geq r$.

If we take the income variables only in the context of a sovereign single currency state, high domestic savings would build up financial wealth, while high investment would generate higher growth. Lower taxes may stimulate demand,

but if the economy is booming, the excess revenue ought to be used to pay back previous debt. By making national current accounts the policy target in the unified Monetary Union, one treats what is effectively a region of the Euro Area as a separate, autonomous and independent unit and ignores the spill-over effects between economic sectors and regions. Assuming that the Euro Area as a whole has a balanced current account, we can decompose equation (1) into two sectors standing for region 1 and 2:

$$(2) \qquad CA = CA_1 + CA_2 = 0 \rightarrow CA_1 = - CA_2$$

whence

$$(3) \qquad (S_1 - I_1) + (T_1 - G_1) = -(S_2 - I_2) - (T_2 - G_2)$$

It is then obvious that the current account position of one region is the mirror of another region. If the household savings in one region are insufficient to finance local corporate investment, the savings balance from another region will provide the funds. It is often argued that the Euro Area does not function as a fully integrated currency union because it lacks fiscal transfers. Amongst governments, a "transfer union" would imply that the budget surplus of one government finances the deficit of another government:

$$(4) \qquad (T_1 - G_1) = - (T_2 - G_2) \qquad \text{"Transfer Union"}$$

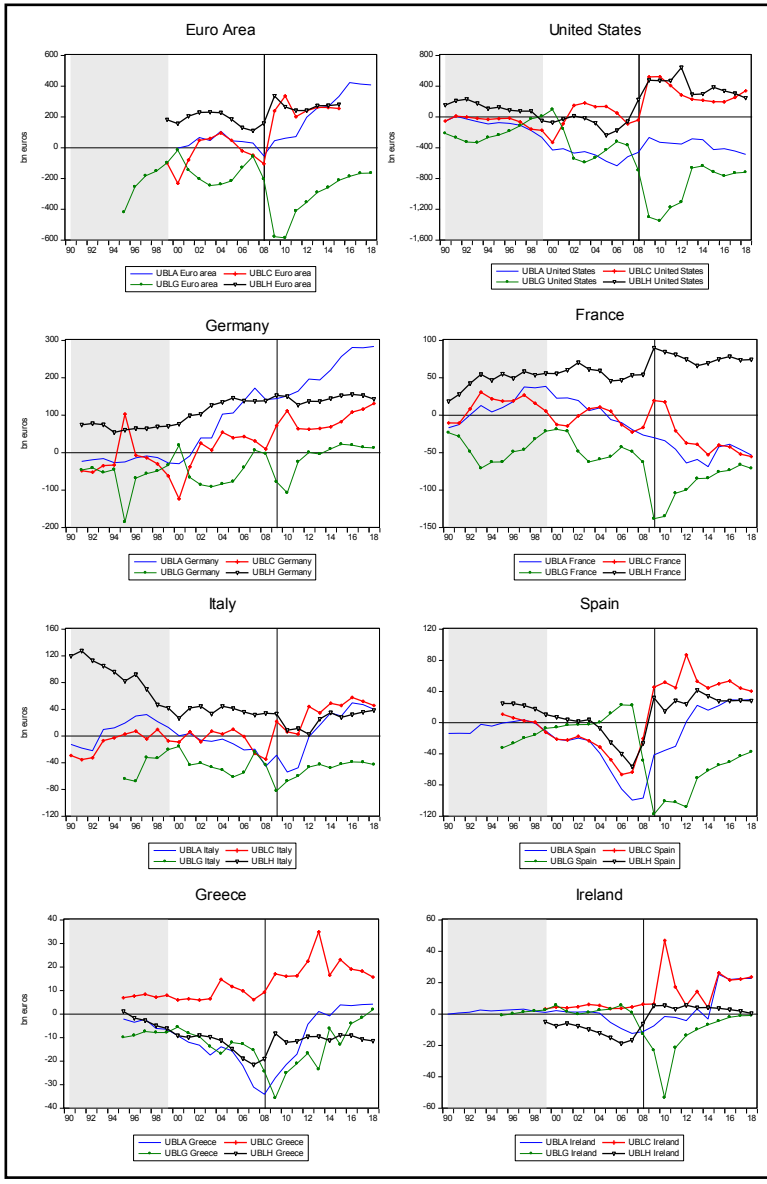
But clearly, a transfer union or fiscal federalism is not the only possible way for transferring funds in Monetary Union, because the savings-investment balance in the private sector

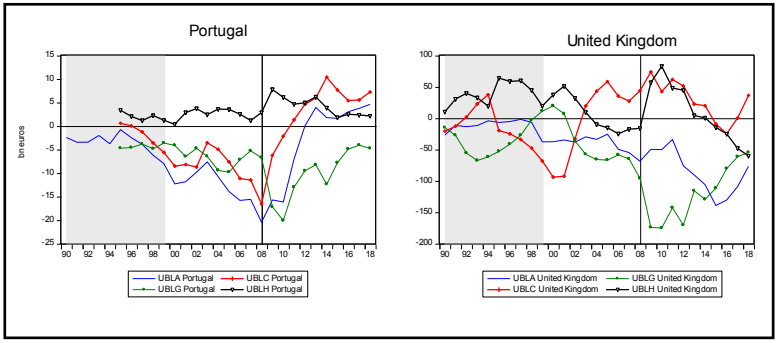
may fulfil this function. The proper policy mix among these variables is conditional on the specific economic environment in a given region and in the Euro Area as a whole. The focus on current account imbalances does not allow such differentiated assessment. What is needed is a more differentiated assessment of the effect that each of these variables has on economic growth.

Flow of funds in the Euro Area

The appropriate tool for such analysis is the flow of funds statistic. It records the cash flow across different economic sectors and can be disaggregated from the Euro Area level down to member states, regions and economic sectors. Typically, simplified textbook models assume four functional sectors: households save and lend, the corporate sector borrows and invests and ideally the government balances its budget and there is no need to borrow or lend abroad. However, in reality substantial distortions may occur – sometimes for a long time. Households may borrow excessively, especially during a real estate boom. Banks may not be lending to corporations given the levels of expected returns, risks, uncertainty, and the constraints imposed by rules and regulations. Corporations may need to reduce the leverage of their balance sheets and save profits rather than invest. If a region has been hit by a negative demand shock, it might be appropriate for governments to stimulate demand by spending more. Flow of fund statistics can provide a clearer picture of what kind of policy response is needed. Figure 1 shows the flow of funds for seven member states of the Euro Area, as well as for the UK and the USA.

Figure 1. Flow of Funds in selected countries





Note: UBLA is the current account deficit; UBLC is net lending of the corporate sector; UBLG is the government budget position; UBLH is the net lending (+) by households.

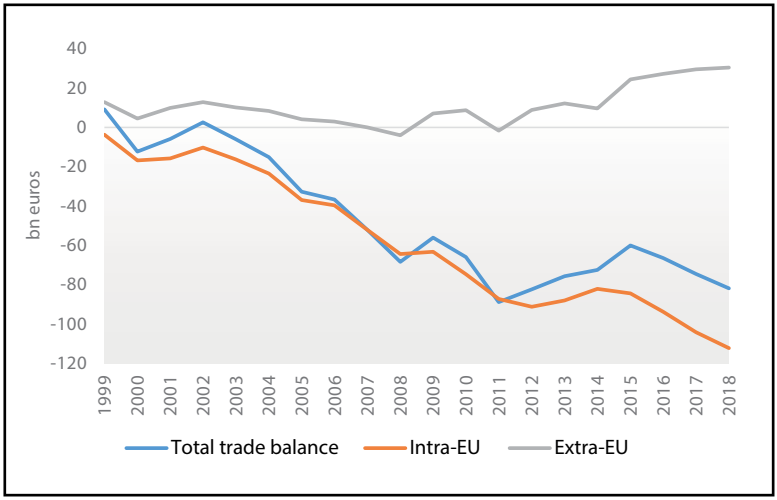
On aggregate, the Euro Area shows the normal textbook features, whereby households save and lend to corporations, immediately after the start of Monetary Union and before the financial crisis broke in the USA. Since then household savings have increased substantially and the corporate sector no longer borrows but pays back debt and deleverages balance sheets. Only governments are still borrowing funds, although fiscal consolidation after 2011 has slowed down this only remaining source of aggregate demand. Not surprisingly, the current account position of the Euro Area with the rest of the world has risen into surplus. Hence, it is clear that the focus on reducing current account imbalances has sharpened austerity, handicapping growth and the return to full employment.

Our flow of funds analysis for the United States shows that public borrowing has been the driver of economic growth in the US economy during the Obama years,

while the corporate sector has used profits to deleverage debt rather than to invest. It remains to be seen whether Trumponomics will change these dynamics. Financial deregulation may encourage taking out more corporate debt, even if it takes time, but the most likely effect of the new policy mix with protectionism, increased public spending and reduced taxation is stagflation with rapidly deteriorating current accounts.

If we look at individual member states, we find that the patterns in Italy, Spain and Portugal resemble the Euro Area, at least in recent years. France is the only country that functions as in the textbook model: there households save, corporations borrow. Yet, because the government also borrows, national savings need to be complemented by savings from abroad. If we take the French trade balance as a proxy for the current account position, we see in Figure 2 that most of the French external deficit originates in intra-European trade, while external net exports compensate approximately for a quarter of these net imports. A closer look at the data (not shown here) reveals that during the austerity years, French demand and therefore imports temporarily (2011-2014) declined, but most of all lack of demand from other member states, i.e. French exports, stagnated. France fulfils a crucial function in the Euro Area today: it is the only country which absorbs the excess savings from other member states. By using current account statistics rather than flow of funds this fact remains hidden.

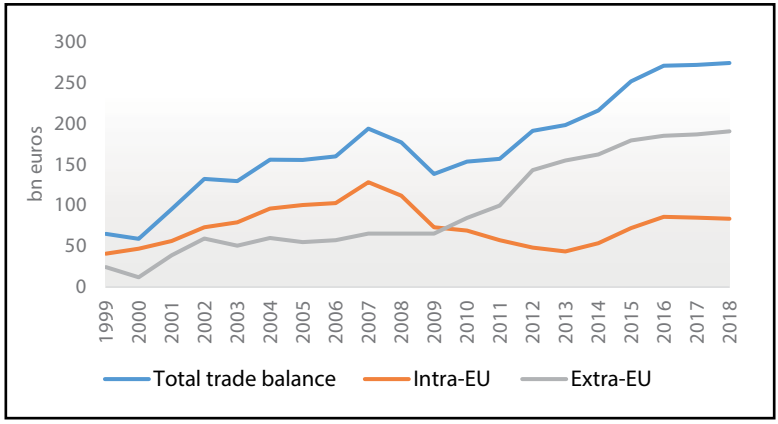
Figure 2. France: Trade Balance



The most distorted country of all is Germany. Here, all sectors are saving and lending; no sector is borrowing. It is interesting that before the Global Financial Crisis, Germany was the main provider of funds for the European Union, but when austerity reduced the demand for funds, Germany switched lending to non-European countries and benefited from demand coming from a world that was not handicapped by austerity. See Figure 3. Thus, Germany is a savings machine that lends to the rest of the world and prevents other European regions from growing through exports because it does not buy. In fact, Germany is the prime channel through which the Euro Area accumulates foreign exchange reserves and financial claims on the rest of the world, but this financial wealth does not spread to other member states. Yet, the enormous contribution that Germany makes to the growing imbalances in Europe goes largely undetected by the macro-

economic imbalance procedure, because, on the one hand, the thresholds (of +6% and -4%) for surpluses and deficits are asymmetric, and on the other hand, it is not clear that the cause is insufficient investment by German corporations.

Figure 3. Germany: Trade Balance



Regarding outside EU countries, we observe from the flow of funds in Figure 1 that the UK's rapid economic growth in recent years is fuelled by a consumer boom. This is unsustainable. The household sector as a whole is not saving but borrowing amounts similar to the government. Perversely, the only sector that generates savings is the corporate sector, but it uses these funds to deleverage balance sheets. Given these insufficient household savings, the UK has to borrow abroad. The consumer boom translates into a huge trade deficit with the EU, and a smaller one with the rest of the world. See Figure 4. However, the situation has improved after the crisis with respect to non-European trade balances. Figure 5 shows that, because of reduced demand, British exports have

suffered from austerity in Europe, but have picked up since excessive austerity has ended in 2016, while exports to the rest of the world have improved during this period. Thus, European austerity has inverted the trade incentives for the British economy, and this may well have contributed to the public disenchantment that has led to Brexit.

Figure 4. United Kingdom: Trade Balance

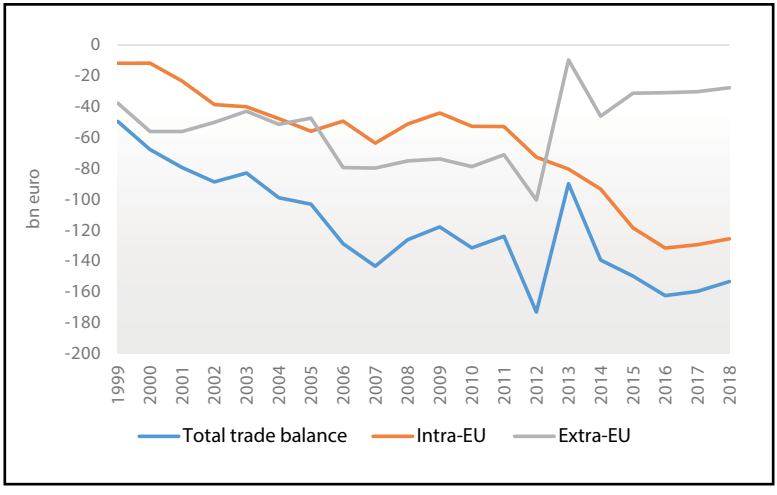
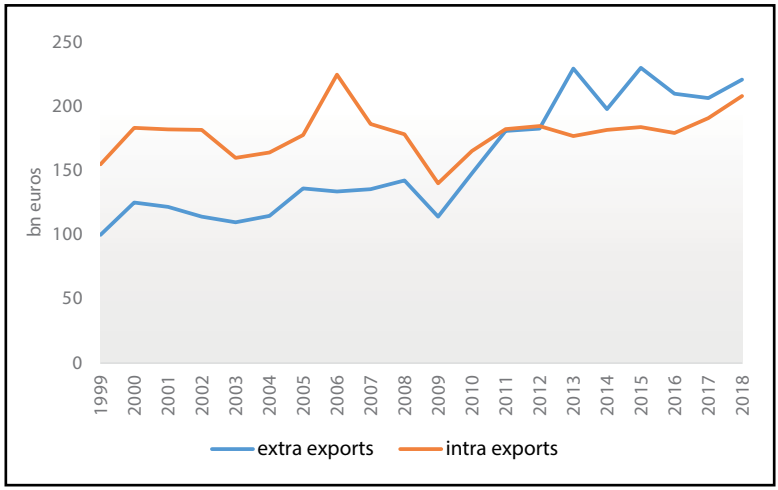


Figure 5. British Exports



The competitive imbalances

A better way to detect macroeconomic imbalances is by looking at the flow of funds than at current account statistics. However, simple economic wisdom tells us that lenders ought to put their savings where it yields the highest return. This is why competitiveness matters. Financial markets asses the investment opportunities, but the macro environment of competitiveness will determine where returns on capital are attractive. In its MIP, the European Commission uses unit labour costs as a measure for competitiveness. However, it is well known that this indicator does not indicate competitive positions in levels, but only the cumulative dynamics following the base year. This greatly reduces its usefulness.

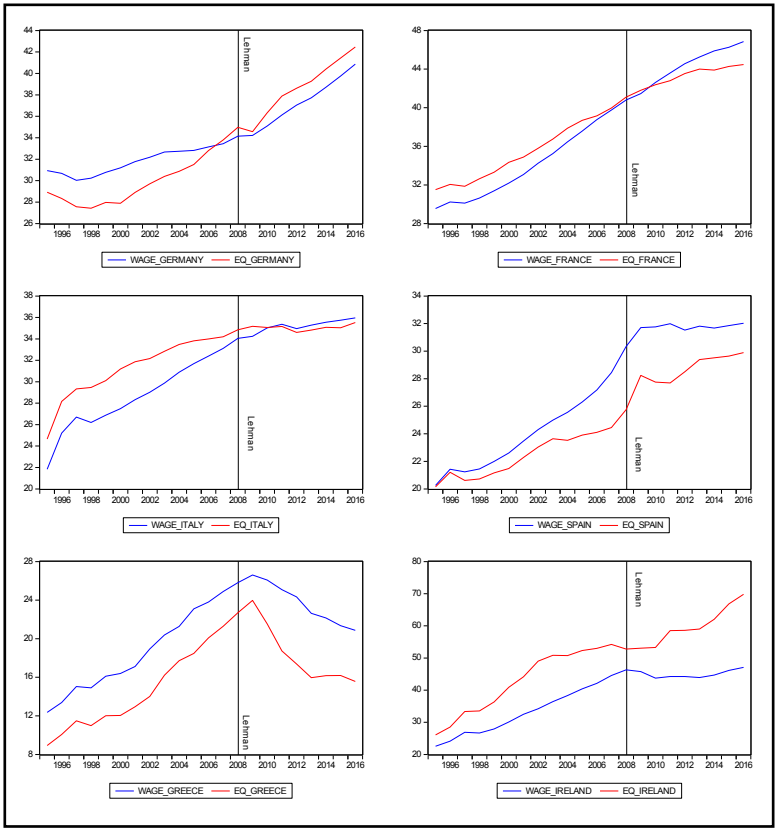
A proper assessment requires an index that measures the *levels* of labour cost competitiveness. This can be done by calculating and comparing a specific country's wage cost against the benchmark level at which the returns on capital in all regions and sectors would be equal to the average of the Euro Area.[5] The wage compensation, which would generate the same return on capital in a given country or sector as in the Euro Area average, I call equilibrium wage. Note, however, that we must not confuse this equilibrium wage with the neoclassical idea of a market-clearing wage at the natural rate of unemployment. If wage costs are above this equilibrium level, the return on capital is less than the Euro average, therefore indicating a competitive handicap. The wage competitiveness indicator is then calculated as the ratio of actual wages relative to this benchmark equilibrium wage. Labour compensations below this level generate competitive advantages and ought to attract investment and support faster growth.

An interesting feature of this equilibrium wage is that it is determined by relative capital productivities and technological progress.[6] It therefore links wage-setting policies to economic growth and supply-side policies. For example, the increase in capital productivity (and its mirror image, the reduction in the capital-output ratio) explains Germany's improved equilibrium wage in the first Euro-decade and the opposite effect in Greece after the Euro crisis imposed austerity (Collignon, 2016).

Figure 6 shows the development of actual and equilibrium wages for some selected Euro member states. In Germany, the competitive disadvantage of the 1990s has been overcome by improvements in the productivity of

the capital stock[7] that were faster than in the Euro Area, so that the equilibrium wage increased. Actual wages also started to accelerate, especially after the crisis, although not enough to erase the advantage. This is very different when compared to other countries. In Spain and Ireland the equilibrium wage stagnated before the crisis, but has picked up since. While nominal wages have stagnated in both countries, the evolution of the equilibrium wage has improved competiveness in Ireland and lowered the disadvantages in Spain. In France and Italy we detect a tendency of long-run stagnation for the equilibrium wage, which is not fully interiorized in wage bargaining. This reflects supply-side weaknesses and insufficient improvements in capital productivity. Greece is a sad story: nominal wages have dramatically fallen, but the equilibrium wage level even more, so that the return on capital in Greece is rapidly deteriorating. This is largely a consequence of the harsh austerity policies, which have reduced domestic demand and economic growth at a rate faster than that by which existing capital capacities are destroyed. Hence, Greece proves that austerity is not necessarily an instrument for improving competitiveness.

Figure 6. Actual and equilibrium labour compensation, 1994-2016



The gap between actual and equilibrium labour compensation is our measure for competitiveness. Figure 7 shows this gap for EU member states as well as UK, USA and Japan. A negative gap indicates a return on capital above the Euro Area average, which potentially improves the conditions for economic growth. Now, because our gap is

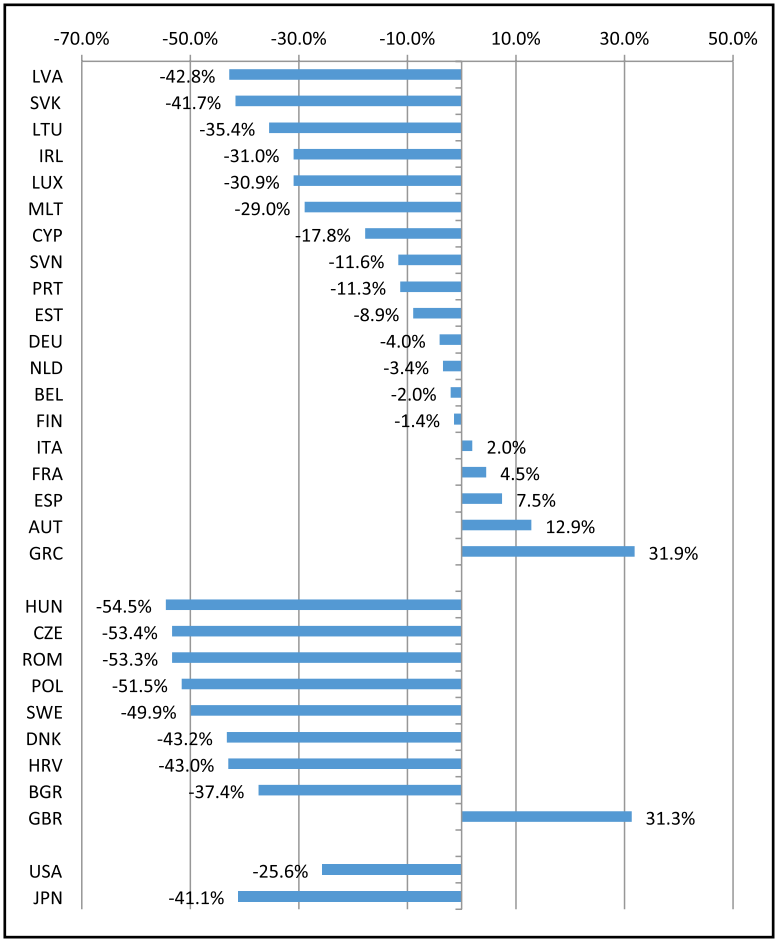
the difference between actual and equilibrium wages, the exchange rate cancels out. A currency devaluation only affects our competitiveness index to the extent that it affects the current account balance between different currency areas.

It is a fascinating insight that the biggest imbalances in wage competitiveness are occurring in the small mostly Eastern new member states, where the productivity of the capital stock has improved most rapidly during the transition from plan to market. However, because of excessive wage restraint, actual wages are 30-40 percent below the equilibrium level inside the Euro Area and even more in the rest of the EU. Wage levels in Italy, France, Spain, Austria and Greece are uncompetitive, because nominal wages are growing faster than the equilibrium level. This represents mainly insufficient growth in productivity. German wage levels are 4 per cent below equilibrium, which matters because Germany is a large economy, but the distortion is hardly as bad as Germany-bashers claim. Germany contributes to distortions in Europe not so much by low wages, but by excessive savings and insufficient spending.

With respect to wage levels in the United States and Japan, the Euro Area is too expensive and this is because capital productivity is too low. Because we calculate capital productivity as nominal GDP to the nominal value of the aggregate capital stock, the underutilisation of productive capacities and the capital stock due to excessive austerity has damaged European competitiveness and contributed to macroeconomic imbalances between member states. Devaluing the Euro would only change this if it contributed to higher productivity, which depends on the degree of openness and the degree of capacity utilization.

What Europe needs is an economic strategy that restores adequate and balanced growth. Protectionist policies would not improve economic conditions.

Figure 7. Wage gap between actual and equilibrium wages (in percent of equilibrium wage)



Overcoming regional imbalances in the Euro Area

This article has argued that the Macroeconomic Imbalance Procedure as it is presently set up in the European Union is inadequate and even counterproductive for avoiding significant distortions among Euro member states. The excessive focus on balancing current accounts imposes austerity that reduces productivity improvements and thereby amplifies competitiveness problems. While current accounts are meaningful for serving exchange stability within the single market, they are meaningless in the single currency area. Instead, it is necessary to sustain economic growth at levels which allow servicing debt contracted in Euros.

This links economic growth and wage bargaining to effective demand management and supply-side reforms which ought to focus on improving productivity and assuring balanced growth across countries and regions in the Euro Area. Such balanced economic performance requires instruments that allow greater force and discretion than the rule-based intergovernmental policy making which is presently practiced in Europe. In-depth reviews and alert mechanisms cannot force unwilling actors to correct what is going wrong. It would be necessary to give policy competences with proper budget funds to a centralized body like the European Commission – properly controlled by the European Parliament – that would allow targeted investment and structural reforms especially in weak economic areas.

Notes

1. See: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure/dealing-macroeconomic-imbalances_en Notice also the increasing bureaucratization of linguistic styles in the European Union. SGP, MIP, AMR and IDR, Six Pack etc. are labels that are wielded skilfully by a small circle of experts, but unintelligible for ordinary citizens. One is reminded of the old Soviet Union.
2. Base money is money created as credit given by the central bank to commercial banks. Book money is a multiple of base money created by bank loans.
3. Such fanciful talk is found in: (Sinn & Wollmershaeuser, 2011).
4. For an in-depth analysis of public debt dynamics under the rules of the European Stability and Growth Pact see (Collignon, 2012)
5. We define nominal equilibrium wages as the total labour compensation level, at which the average return on the capital stock in a given economy is equal to the average return in the Euro Area as a whole. The return on capital is the ratio of non-wage value added relative to the historic value of the aggregate capital stock of a country or sector. For details see (Collignon, 2016); (Collignon & Esposito, 2017).
6. (Collignon & Esposito, 2017) show empirical evidence.
7. We use the data provided by Ameco and Eurostat for capital productivity that calculate capital productivity as the 30-year cumulated value of net investment. This is a nominal value. The return is the operating surplus (value added minus wages). These data incorporate price effects as well as physical productivity as incorporated in technological progress.

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Coordinating wages in the European Monetary Union: practical experiences and lessons to be learned

Ronald Janssen

Trade union initiatives to set up the coordination of collective bargaining rounds go back as far as the early 1990s. The European Metal Federation (EMF), as it was then called, was probably the frontrunner. Concerned by the fact that one of their affiliates, in particular in the Netherlands, had accepted a cut in real wages by agreeing to a nominal wage increase lower than inflation, the EMF reacted by setting up an internal committee to discuss, compare and evaluate collective bargaining in the metal sectors around Europe. In order to avoid competitive wage moderation, the EMF put forward the criterion that collectively bargained wage increases were to amount to the sum of inflation and a fair share of productivity. This was followed, in 1998, by the so-called Doorn-Initiative, where trade unions from Germany, Belgium, the Netherlands and Luxembourg set up their own coordination platform and

pledged to bring wages in line with the sum of inflation plus productivity growth. A year later, at its congress in Helsinki, the entire ETUC followed suit and organised their own European wide collective bargaining committee, using the same formulae as the Doorn group.

It is interesting to elaborate on the formal reasons why the ETUC congress decided to engage in bargaining coordination. Three objectives were mentioned: With the introduction of the euro, currency devaluations were no longer possible and the ETUC wanted to avoid replacing them with wage competition among members of the euro area. Recent history has shown that this concern about wage devaluations being used as a surrogate for currency devaluation was well-founded. A second objective was to ensure workers from Central and Eastern European countries would get their fair share of the benefits of European Union enlargement: If, thanks to integration within the internal market, productivity were to increase in Central and Eastern Europe, then real wages should go up similarly. Third, and tellingly, the ETUC also made a link between wage coordination and the price stability mandate of the new central bank of Europe, the ECB, by claiming that such coordination among trade unions of Euro Area member states was desirable and necessary to avoid policy conflicts that could damage economic growth by having wage actors and monetary policy actors pulling the economy in two opposing directions.

The first decade of Monetary Union: The reality

The first and also the latter motivation testify to the fact that actors such as the ETUC and its trade unions were

well aware of the implications of monetary union (MU): Members of a monetary union cannot go their own different ways. If they do so, tensions within the system build up and sooner or later, the union will be confronted with the fact that a single monetary policy with its single interest rate and its single exchange rate has become entirely inappropriate for the majority of its members.

Unfortunately, this is exactly what happened during the first decade of MU: On the one hand, member states such as Spain, Ireland, Portugal and Greece were "riding" the cheap capital boom that MU was offering. Upon joining MU, risk premiums in interest rates disappeared and capital flooded into their economies. Cheap and easy capital was then allowed to trigger a debt-driven economic boom, either through a housing price bubble (Spain, Ireland), or through a public expenditure spree (Greece). The economy boomed and so did inflation. This, in turn, accelerated the boom as the combination of robust inflation and a relatively low single nominal interest rate set by the ECB resulted in real interest rates that were too low for these economies.

On the other hand, the core economies of MU (read: Germany) opted to stick to and even intensify the model of "competitive disinflation". Policy-makers put downwards pressure on wages by weakening labour market institutions (Hartz reforms) and by threatening trade unions with intervention in collective bargaining should they opt out of "job alliances" at company level. The latter, together with firms increasingly cancelling their membership of employer associations that had bargaining rights, resulted in German trade unions widely accepting company-level opening clauses in sector agreements. All of this worked to depress or even

virtually cancel wage dynamics. From 2000 to 2007, for example, real wage growth in Germany was minimal and average nominal unit wage cost growth was zero. As a result, inflation was pushed down as well and whereas Germany, before MU, was evolving close to a 2% inflation target, inflation in the mid-2000s went down to 1% and in some years even lower. As with the peripheral economies, the single monetary regime accelerated these disinflationary and depressive forces by setting a single interest rate that, in this case, remained too high.

While this scenario of economic divergence went on for almost an entire decade, imbalances began building up. Year after year, Spanish and Irish households and firms as well as the Greek sovereign happily took on ever more debt, debt that was (macro-economically) necessary to finance their high current account deficits. On the other side of the game, Germany saw its current account (which was slightly negative at the start of EMU) steadily grow into a giant surplus that peaked in 2008 and this despite an enormous appreciation of the euro against the dollar and other currencies.

Sooner or later, however, reality had to catch up. Once financial markets (finally?) realised that debt and financial positions among households, corporations, banks and governments in the "debtor" countries were unsustainable, the whole finance system ground to a halt. Capital became bottled up in the core and stopped flowing to the rest of MU. With the financial sector effectively going on strike, the economy in a major part of MU (the deficit countries) collapsed. In short, the euro crisis was born and the Euro Area became split between "creditor" and "debtor" nations.

The signature of imbalances

While, as described above, wages also played a role in building up huge imbalances in current account and debt positions, it is not entirely clear whether they were a causal factor or whether wage developments were driven by other factors. Formally, policy-makers rapidly decided on the first approach by falling back on the traditional, mainstream argument of competitiveness. In this view, wages in the deficit countries had, for some reason ("irresponsible" trade unions), spiralled out of control. This damaged competitiveness, thus harming exports and substituting domestic production with imports so that current account deficits soared. These external deficits had to be financed, however, and this was done by private sector actors (households, corporations) indebting themselves through the banking sector. In this view, the Great Financial Crisis or the euro crisis at least is not so much a financial crisis but in the first place a crisis of competitiveness and wages.

Another view, however, is that the causes go the other way and that wages in the deficit countries did not simply explode on their own but were a symptom triggered by another factor. In this view, the real driving force of imbalances in deficit countries was massive capital flows that entered the economy, thereby causing a debt-financed, asset bubble-based boom which increased both inflation as well as the current account deficit. The external deficit increased, not so much because of falling exports but because of rising import demand. With inflation (and housing prices) going through the roof, wage dynamics were also pushed up. In fact, an argument can be made that, had it not been for

responsible social partners and coordinated wage bargaining setting (low) maximum limits to wage demands, imbalances would have been much worse. In Spain for example, national agreements on framing wage negotiations were used to set a (lower) maximum on wage increases, thereby also taking the ECB's price stability objective into account. If it had not been for this practice of coordination, wage dynamics in Spain would probably have been much more dynamic. In this view, wages and bargaining in the deficit countries are more of a consequence, not the cause of the euro crisis. Several pieces of research, sometimes from unexpected quarters such as the ECB and the Banque de France (Gaulier/Vicard, 2013) or the IMF (Chen et al. , 2012) , back up this latter view and argue that the signature of imbalances in the Euro Area is indeed financial, in other words that capital flows, not deteriorating competitiveness, constituted the driving force.

To reiterate: these capital flows did not come out of the blue. On the supply side, capital flows were helped along by the strategy of wage restraint in Germany which boosted profit margins but not reinvestment. This resulted in massive but idle corporate cash, cash that was subsequently channelled through the interbank system into a financial bubble in other members of the Euro Area. Viewed from the other side of the equation (the deficit countries), there was also a pull or demand side factor: The euro's introduction significantly reduced risk premiums in interest rates on Spanish, Portuguese, Greek bonds, thereby creating more demand for credit and capital in the deficit economies. In some cases (Spain for example), national policy was not helpful either as the housing boom was further fuelled by easing regulations on land use, thereby making more land available for

construction purposes. Moreover, the single monetary policy regime worked to extend these destabilising forces. In the booming economies, the fall in nominal interest rates associated with the disappearance of the risk premium was intensified by rising inflation so that the real interest rate went down even further. In Germany, the opposite was the case. Falling and extremely low inflation came on top of what was already a relatively over-strict nominal interest rate (set by the ECB) and worked to push up the real interest rate as well.

Despite the evidence supporting the alternative view that capital flows rather than wage competitiveness was at the core of the crisis, Euro Area policy-makers decided to blame wages and ignore the mismanagement of finance and capital flows: Excesses in wages had gotten the euro into trouble so wages were seen as the way to get the euro out of the crisis, especially since national currency devaluations could no longer be used to restore competitive positions. What undoubtedly also played a role in this policy choice of 'internal devaluation' was the pressure coming from the ECB to provide financial support to crisis countries only if their governments undertook structural reforms to weaken the bargaining position of workers and trade unions.

The failure of internal devaluation

It is an understatement to claim that this policy of squeezing wages was not a huge success. Internal devaluation, together with fiscal austerity, seriously depressed domestic demand in several Euro Area member states and this spilled over into

the rest of the Eurozone. A double-dip recession was triggered and, in the end, it took the Euro Area almost a decade to simply get back to the pre-crisis level of economic activity. (Bibow and Flassbeck 2017). There are three reasons for this dismal record of internal devaluation:

1) While wage moderation was supposed to restore competitiveness by flowing into lower prices, in Spain, Greece or Portugal a substantial part of wage squeezes simply fuelled higher profit margins. Given that the deficit countries were facing a sudden stop in capital flows, this does not come as a big surprise. Indeed, with the financial sector going on 'strike', many companies, in particular SMEs were hit by a credit squeeze. Banks already confronted with reduced access to market funding and with capital losses on their sovereign debt portfolios, became much more selective in rolling over corporate loans and extending new credit. Being shut off from credit, business decided to look for an alternative source of finance and found it in the form of substantially increased profits that were retained as internal finance. In this respect, internal devaluation can be seen as a (poor) substitute for financial policy: In the absence of a functioning banking system, workers in the deficit countries were pressed into taking over the role of bankers as wages were used as an instrument for internal finance. However, the real wage cuts this implied boomeranged as business had to confront an additional weakening of demand for their goods and services. Instead of squeezing wages, the correct policy reply would have been to fix the Euro Area monetary transmission mechanism to make sure credit to business flowed again, including in the 'deficit' countries. Starting from mid-2012 (with Mario Draghi's pledge to do

'anything it takes to save the euro'), efforts to unlock credit were gradually taken up by the ECB, ultimately resulting in the launching of full quantitative easing (QE) from 2015 onwards. By that time, however, the policy of internal devaluation had already inflicted serious damage.

2) Internal devaluation also relies on the assumption that price adjustments play a determining role in correcting intra-euro trade imbalances. The idea is that wage compression would help relocate economic activity from the core Euro Area to its Southern part, thus raising exports and compressing imports in the latter. But this idea ignores the fact that there are pronounced structural differences between the different Euro Area economies. Germany, in particular, is heavily specialised in highly complex, high value-added production. Here, it is not the price but the quality and the know-how that matter for competitiveness. This implies that squeezing wages in the "deficit" countries does not dent Germany's competitive edge much as the areas of specialisation are very different and as goods produced in Germany are in high demand irrespective of their price. A clear confirmation of this structural difference can be seen from the fact that the German current account surplus, despite almost ten years of internal wage devaluation in the South of the Euro Area, has increased further and reached the stunning record of almost 9.2% of GDP in the second quarter of 2016. Despite intra-euro rebalancing in the form of internal wage devaluation, Germany simply shifted imbalances and started to export even more to the rest of the world outside the Euro Area (where demand was not depressed). This testifies to the real strength of the German economy which lies in producing complex and quality goods and services in high demand globally (machinery, chemicals,

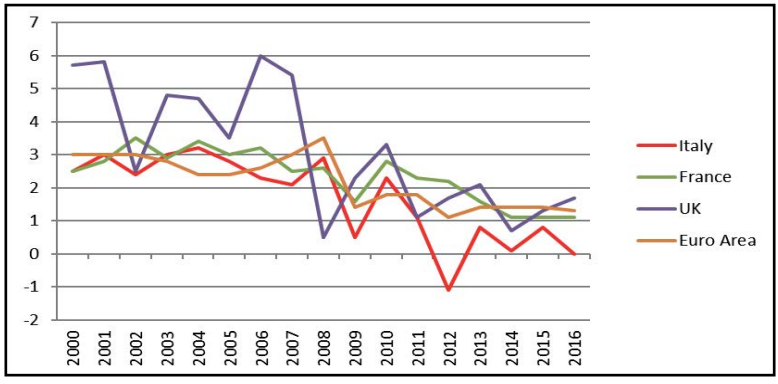
transport and network equipment, engineering) and not in cheap wages (Felipe/Kumar, 2011, Abdon et al., 2010, Storm, 2016). Euro Area members implementing internal devaluation, instead of correcting the external surplus of the core, ended up competing against each other, thereby exporting unemployment and depressed demand to each other and other Euro Area trading partners not as structurally strong as Germany.

3) A third reason for failure, also known in economic theory as the problem of debt deflation, is that the real burden of debt increases. While internal devaluation is pushing wages down, workers and their households still have to service a debt load that does not change in nominal terms. The rigidity of nominal debt, combined with falling wages, then crowds out spending on goods and services, thus delivering yet another blow to aggregate demand and economic activity. Or alternatively, if households start defaulting on debt that they find harder to service, this creates additional pressure in the banking sector. As the portfolio of non-performing loans starts to expand and banks are forced to register provisions for these, the capacity of banks to extend credit to the economy receives another blow. These problems are particularly serious for economies that are already highly indebted like the Euro Area deficit countries. Increased price competitiveness then comes at the expense of aggravating debt overhang problems. These concerns can occasionally be identified in IMF papers where it can be read that there is a 'risk that an internal devaluation accomplished by low or falling inflation in deficit countries could aggravate debt overhang problems' and that 'this could undermine domestic demand, especially if sovereign/bank real economy adverse links remain active' (Tressel et al. 2014, p. 23).

EMU at present: Time to reboot coordination of collective bargaining?

Meanwhile, after several years of intervention and structural reforms in collective bargaining systems, policy-makers have got what they wished for. Wage dynamics across the entire Euro Area have broken down, with the most recent numbers showing that average wages went up by a mere 1.3% in 2016. And while pay rises in France and Spain are even slightly below this level (around 1%), workers in Italy and Belgium are confronting nominal wage freezes. The Euro Area economy may have recovered somewhat from the Great Financial Crisis but for wages there is no recovery in sight (see TUAC, 2017).

Graph 1: Nominal Compensation per employee (change in per cent against previous year)

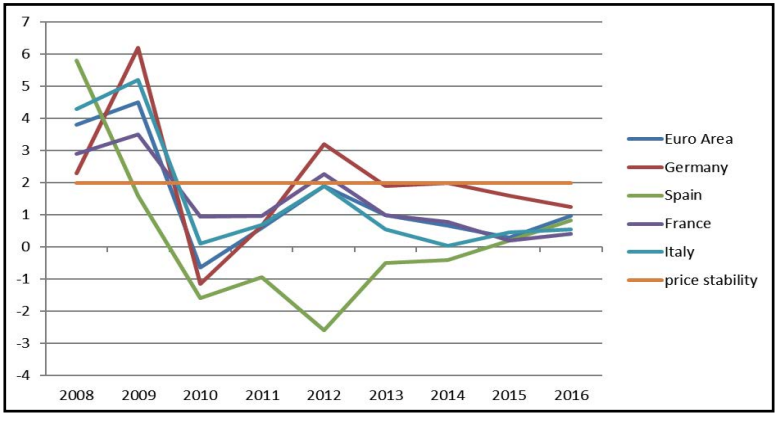


Source: OECD Economic Outlook November 2016, statistical annex

This raises two concerns.

Extremely weak wage dynamics eventually show up in core inflation. With wages increasing by a mere 1.3% and with productivity increasing at around 0.5%, this leaves unit wage costs rising at a rate of about 0.8%. There is no pressure from wage costs on business to raise prices at rates compatible with the price stability target of the ECB (2%); on the contrary, too slow wage growth is sustaining the trend of missing the inflation target (see Graph 2). In fact, leaving aside volatile oil prices, core inflation in the Euro Area is currently still at around 1%, thus almost exactly corresponding with the sluggish dynamics seen in unit wage costs. Even those policy-makers (ECB, OECD, IMF) who in the past have been the most aggressive in pushing wages down have recently been seen to warn against excessively low wage increases as these would be disinflationary (for an overview see Janssen 2016).

Graph 2: Nominal unit Wage Costs, annual change

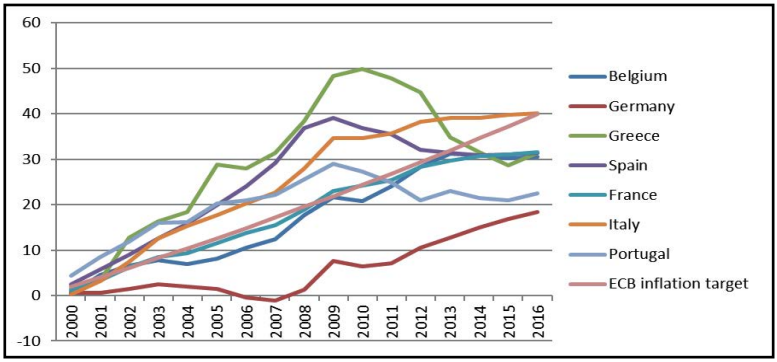


Source: AMECO

Besides pushing many Euro Area economies to the brink of deflation, a second concern is that the policy of internal devaluation may ultimately spiral out of control. This risk can be identified by looking back at wage cost trends since the start of MU. From the graph below, one can see that the different parts of MU tend to switch places over time. In the first ten years, the deficit countries experienced unit wage cost dynamics *above* the trend compatible with price stability (which boils down to a 2% increase each year) whereas wage costs in France (and Belgium) neatly followed the price stability line. In Germany, however, unit wage costs simply stagnated and were thus way *below* the price stability line. However, from the Great Financial Crisis onwards, member states swapped places (as can be seen from the slopes of the lines in the graph). German unit wage cost dynamics started to move back towards being more in line with price stability. Meanwhile, the original deficit countries along with others such as France not only adopted the pre-crisis German wage model of stagnating unit wage costs but, in several cases, went even further by *reducing* unit wage costs. Here, the risk to be aware of is that, as the competitive wage position that Germany secured during the first decade of MU is being steadily eroded, the pressure to implement a renewed round of wage moderation may again start building up. In the event of a negative shock that pushes up unemployment (Trump inflicting damage on world trade and the German export machine?), the argument that the German economy needs to rebuild its wage competitive advantage may again become pervasive. If this were to happen, if Germany again joins the 'wage devaluation' club, then the policy of 'internal devaluation' would really turn into a Euro Area-wide policy, with all the

consequences of further disinflation and severely depressed demand across the entire zone (see also Janssen, 2015).

Graph 3: Wage Moderation spiralling out of control? Long term trends in nominal unit labour costs



Source: AMECO

Conclusion

Coordination of collective bargaining in MU is important. The absence of successful wage coordination can indeed be seen as one of the underlying causes of the euro crisis, as a strategy of wage moderation in one part of the Euro Area ended up not in more investment there but in capital flowing into other parts. This, in turn, resulted within the latter economies in rising asset prices and in an economic boom that was debt-financed but that ultimately ended in a bust.

At the same time, attempts to coordinate collective bargaining or, as seems to be the Commission approach, to "impose" wages policy through expert councils on produc-

tivity need to avoid the trap of adopting the narrative of wage competiveness, in which all of us have to become more competitive against the rest of us. Such an approach is dangerous both from an economic perspective (risk of deflation and of undermining overall demand across the Euro Area) as from a political perspective – there is no better way to 'divide and rule' workers across Europe than claiming that jobs in country A depend on poaching them through wage moderation from country B.

Coordination of wage bargaining should instead focus more on macroeconomic objectives such as the need to keep wages in line with the price stability target of the ECB and on their role as an engine for aggregate demand. Current conditions in the Euro Area (sub-optimal low core inflation, weak recovery held back by a lack of demand) may present an opportunity to give bargaining coordination a fresh start. The question is whether trade unions and social partners in general will seize this opportunity of taking on the role of a 'caretaker' in ensuring that wage dynamics across Euro Area national economies is compatible with the ECB's price stability target.

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European coordination of collective wage bargaining in times of crisis

Torsten Müller

European interventionism as a new policy style

During the crisis, European policy-makers gradually set up a new system of European economic governance, which paved the way for a new policy style of European interventionism (Müller 2015, Schulten and Müller 2015). This new policy style is characterized by three main features. The first is a shift in decision-making powers from the national to the European level, enabling European policy-makers to directly influence policies at national level. This also applies to policy areas in which the Treaty on the Functioning of the European Union (TFEU) explicitly rules out any EU competences, such as social policy and wages and collective bargaining. The second is the strengthening of executive bodies such as the European Commission, the Economic and Financial

Affairs Council (ECOFIN) and the Governing Board of the European Stability Mechanism (ESM) vis-à-vis the arenas for parliamentary action – both at European and national level (Oberndorfer 2013). And the third is the strong focus on so-called 'supply-side economics' based on austerity policies, deregulation and internal devaluation as the central elements of European crisis management.

In principle, attempts by the EU to influence national wage policies are nothing new – even though Article 153 (5) of the TFEU explicitly excludes any competence for it in this area. The Broad Economic Policy Guidelines, for example, which have been regularly issued by the European Commission and the European Council since 1993, have always included demands for more moderate and more dispersed wage developments (Hein and Nichoj 2007). These demands illustrate that already at that time the European institutions followed the dominant paradigm of a competition-oriented wage policy. However, due to their non-binding character, their practical implications on national wage policies remained very limited.

This situation changed fundamentally in 2010 with the new system of European economic governance which established two main channels of intervention in national collective bargaining. The first relies on the European Semester and the Macroeconomic Imbalance Procedure (MIP) that enable the Commission and Council to issue 'recommendations' to the member states in the field of wages and collective bargaining. The more binding character of these recommendations results from the possibility of imposing financial sanctions on member states that repeatedly fail to implement them. With regards to content,

the interventions focus almost exclusively on moderate wage developments and the decentralization of collective bargaining in order to increase the downward flexibility of wages (see table 1).

The second channel relies on the quid pro quo of "structural reforms" for financial support provided by the ESM and based on a so-called Memorandum of Understanding between national governments of those countries requiring financial aid and the Troika (consisting of the Commission, the European Central Bank and the International Monetary Fund – and since 2015 also the ESM). Compliance with the imposed reform programmes is subject to inspection by the Troika which may, in the event of non-compliance, threaten to stop that financial support.

The ultimate benchmark for the "reform policies" propagated by the European institutions in its country-specific recommendations and/or Troika policies was a decentralised, company-based bargaining system because that seems to allow companies to adjust better to varying economic developments (Schulten and Müller 2015: 337). Already in the Euro-Plus pact adopted in March 2011, the 17 signatory member states were required to undertake detailed monitoring of their own collective bargaining arrangements in order to assess whether they allow for "adequate" wage flexibility at company level.

The new system of European economic governance therefore marks a paradigm shift in the EU's approach from the acceptance of free collective bargaining to direct political intervention in national bargaining outcomes and procedures. Table 1 illustrates that a majority of EU member states were subjected to this kind of interventionism by receiving instruc-

tions concerning wage developments and/or "reforms" of their collective bargaining systems either through country-specific recommendations under the European Semester or requirements imposed by the Troika (Schulten et al. 2017: 40).

Table 1: European intervention in wage policy 2011-2016

Country-Specific Recommendations in the framework of the European Semester	
Decentralisation of collective bargaining	Belgium, Finland, Italy, Spain
Reform/abolition of automatic wage indexation	Belgium, Luxembourg, Malta, Cyprus
Moderate development of minimum wages	Bulgaria, France, Portugal, Slovenia
Wage restraint/nominal wage development in line with real productivity	Belgium, Bulgaria, Finland, Italy, Croatia, Luxembourg, Slovenia, Spain
Wage development in line with productivity growth/to boost domestic demand	Germany
Avoidance of high wages at lower end of wage scale	Sweden, Slovenia
Country-Specific Agreements between the Troika and national governments in the framework of Memorandums of Understanding	
Decentralisation of collective bargaining	Greece, Portugal
Restrictive criteria for the extension of collective agreements	Greece, Portugal
Cutting/freezing of minimum wage	Greece, Ireland Portugal
Wage freeze/cuts in public sector	Greece, Ireland, Portugal
Wage freeze in private sector	Greece
Nominal wage development in line with real productivity	Portugal, Cyprus

Source: Schulten et al. 2017: 41

All these measures are based on the firm belief that the current crisis is first and foremost one of (cost) competitiveness in which wages and labour costs play the central role (Schulten and Müller 2015). Hence, the economic imbalances between the trade-surplus and trade-deficit countries are viewed as being primarily the result of diverging trends in wages and unit labour costs. Since in a European monetary union deficit countries can no longer improve their cost competitiveness by nominal devaluation of their national currency, "internal devaluation", a euphemism for lowering wage costs, is urged by European policy makers as a way out of the crisis.

The new system of EU economic governance, therefore, has *de facto* established a means of external political coordination of wages and collective bargaining which essentially aims to enforce moderate supply-side oriented wage policies in a bid to improve national cost competitiveness. This model has not only exerted a downward pressure on wages, but it has also undermined various core elements of the trade unions' capacity to act, such as collective bargaining autonomy/coverage (for an overview see Müller and Platzer 2016; Lehndorff et al. 2017).

Against this background, the trade unions in Europe and in particular the European Trade Unions Confederation (ETUC) have emphasised the need to develop an autonomous and demand-oriented alternative model of collective bargaining coordination. This serves two purposes: First, it averts a market-driven downward wage spiral, in which trade unions from different countries are placed in competition with each other; second, it is an integral part of a broader alternative wage- and demand-led growth model, in which higher wages boost internal demand, thus generating growth and employment.

Political framework conditions of autonomous coordination

The implementation of such an alternative model faces two fundamental problems. First of all, even though the negative consequences of current EU crisis management have demonstrated the need for an autonomous alternative model of coordination, the measures introduced in an attempt to manage the crisis have at the same time undermined the institutional prerequisites for the successful implementation of such an alternative approach. In other words, the very actors and institutions needed for an alternative model of coordination have been weakened.

The increasing decentralization of collective bargaining has hollowed out the unions' capacity to coordinate wages and collective bargaining at national level. This has meant that the unions in many countries were no longer powerful enough to push through joint European strategies vis-á-vis the employers. Even before the crisis, many affiliates were in no position to comply with the wage coordination rules agreed within European trade union federations at sectoral and cross-sectoral level; under the crisis-induced regime of austerity and internal devaluation, of course, this became even more difficult, if not impossible to achieve.

Another factor hampering the successful implementation of an alternative autonomous coordination of collective bargaining is the current lack of political support for such an approach. This not only applies at European level but also at national level where the political context is increasingly fraught. Most recent examples are developments in the UK, Finland and France where in 2016 national governments

initiated measures to curb trade union rights and to decentralize collective bargaining. These examples illustrate that the political and institutional framework conditions for an autonomous coordination of collective bargaining have also deteriorated in those countries that so far have largely been spared from direct European interventions in the field of wages and collective bargaining.

Linked to these developments is the second fundamental political dilemma which trade unions face in their efforts to coordinate collective bargaining cross-nationally. On the one hand, union federations such as the ETUC emphasise the importance of collective bargaining autonomy and reject for good reasons any political intervention. On the other hand, however, practical experience illustrates that such interventions are taking place anyway with far-reaching implications at national level. This leaves two basic options: first, root-and-branch opposition or, second, the attempt to influence the interventions in order to prevent the worst implications in the short run and achieve a change of policies in the long run.

Intra-trade union prerequisites for autonomous coordination

The autonomous European coordination of collective bargaining within European trade union federations essentially relies on the cooperation and willingness of the national affiliates. This means that the European federations have no means to force these to comply with the coordination rules/guidelines agreed at European level or to sanction non-compliance. They rely entirely on the moral commitment of

their affiliates to follow the European rules. However, one essential prerequisite for this is the federations' capacity to aggregate the diverse interests of their affiliates and the crisis has rendered this more difficult. The fact that the crisis and efforts to manage it affected the various countries in different ways meant that each affiliate has very different needs and expectations towards the federations. For the trade unions in Greece, Portugal and Spain that were hardest hit by the crisis and ensuing measures, the key priority was no longer wage increases but the defence of the existing system of multi-employer bargaining and job-creation.

The ETUC as the cross-sectoral European trade union federation faces the additional problem that negotiations in national multi-employer bargaining systems usually take place at sectoral level so that national trade unions sometimes question the ETUC's legitimacy and competences in coordinating collective bargaining at European level. The ETUC, therefore, emphasises its role in supporting the coordinating activities of the sectoral federations. However, at the same time, the new European system of economic governance has strengthened the ETUC's coordinating role by providing it with new possibilities to exert political influence within the consultation procedures foreseen in the European Semester.

The ETUC's new coordination approach

This is the context in which the ETUC affiliates discussed the development of a new autonomous coordination approach as an alternative to the political coordination

imposed by the European institutions and national governments. One vital prerequisite was that the new approach take into account the affiliates' need for concrete measures and instruments to come to terms with the effects of the crisis and its management. The ETUC therefore had to address two fundamental questions: What would a differentiated solution look like that could take into account the affiliates' country-specific demands and problems? And: could the ETUC develop guidelines that are at the same time both flexible and credible enough to allow it and its affiliates to achieve more concrete and realistic results?

In October 2013, the ETUC Executive Committee adopted a new method of 'coordination of collective bargaining and wages in the EU economic governance' (ETUC 2013), which was confirmed at the last ETUC Congress in 2015 (ETUC 2015). This new approach consists of three central elements: the adoption of joint collective bargaining guidelines; seeking to influence the decision-making processes of the European Semester; and developing a structured and continuous exchange of information as an essential prerequisite for the formulation of joint positions and strategies.

The first point is reflected in the March 2012 ETUC Resolution which identified four collective bargaining priorities:

- coordinating wage policies by applying the so-called 'golden wage rule' whereby pay increases should (at least) cover inflation and productivity increases while at the same time allowing enough flexibility (both upwards and downwards) to take into account country- and sector-specific circumstances – implicitly, however, the golden wage rule has often been considered as specifying a

minimum floor for wage claims.
- formulating a common position on defensive agreements and opening clauses, emphasizing that these should only be temporary measures;
- developing joint positions on minimum wages and collective bargaining coverage; and finally
- coordinating the fight against wage discrimination with a focus on reducing the gender wage gap.

The second and essentially new element of the ETUC's coordination approach focuses on strengthening the involvement of trade unions in European economic governance. Within the annual European Semester cycle there are opportunities at both national and European levels to influence the policies pursued by the Commission and Council. At national level, trade unions can seek to influence the National Reform Programmes in the field of economic policy and the Stability and Convergence Programmes in the field of fiscal policy. Every April, national governments are requested to develop a reform programme, in which they spell out how they try to fulfil the economic and fiscal objectives defined in the Europe 2020 strategy. The second opportunity presents itself at European level, when the Commission uses these national reform and stability programmes to formulate the annual country-specific recommendations usually published in May. After a debate in the European Parliament, these recommendations are adopted by the Council in June or July. The key objective of the ETUC's coordination approach is to ensure that trade unions are involved at every stage of the formulation of the country-specific recommendations both at national and European level.

Improving the unions' organizational capacities

The third element of the coordination approach is the „toolkit", which was developed by the ETUC's Collective Bargaining Coordination Committee as a means of improving the exchange of information among the affiliates. Transparency and information are key organizational preconditions for coordinating collective bargaining across borders. The core element of this toolkit is an interactive and password-protected website on which affiliates can access all the relevant information on the ETUC's strategic priorities in the field of collective bargaining.

Concerning the European Semester, the toolkit comprises three areas: first, more general information on the European Semester, including the national affiliates' response to the country-specific recommendations for their country. On the basis of these responses, the ETUC compiles a European report on all the country-specific recommendations in the field of wages and collective bargaining. Second, information is gathered about the national affiliates' attempts to influence the formulation of the National Reform Programmes. The objective here is to support the national affiliates by reporting best practice examples and to put pressure on the Commission to live up to their promise of improving the involvement of trade unions. The third element is information on planned or actual interventions upon trade union rights by national governments.

One step beyond: the ETUC's campaign for a pay rise in Europe

The coordination approach confirmed at the last ETUC Congress represents a pragmatic response to the immediate and diverse needs of its affiliates. Its main objective is to enable flexible adaption to the new economic, political and institutional environment that has emerged out of the crisis. In terms of content, the increased efforts to influence the decision-making process within the European economic governance at all levels are a new approach. In terms of procedures, complementing traditional coordination via abstract guidelines with more hands-on elements such as the 'toolkit' is innovative as well. The overarching objective therefore is to move from standardized 'one-size-fits-all' solutions to more tailor-made approaches that can better accommodate affiliates' specific needs.

Nonetheless, the ETUC is sticking to the principle of wage coordination via guidelines such as the "golden wage rule", whereby wage increases should aim to at least cover the ECB's target inflation and productivity increases. In the context of the current crisis this is a very important political message – despite all the practical problems in implementing this approach. By maintaining the principle of a solidaristic coordination of wages in Europe, the trade unions highlight that there is an alternative to the 'competitive' wage policy propagated within current crisis management.

Moreover, the ETUC has recognized the need to go beyond traditional channels of coordination by mobilizing its affiliates in pursuit of a campaign for higher wages. Hence, in February 2017, it launched "Europe needs a pay rise – it's

time for our recovery". The campaign's key objective can be seen in the promotion of a more expansive wage policy as part of a broader macro-economic re-orientation towards a wage-led growth model. This more expansive wage policy takes the 'golden wage rule' as the starting point and adds – if possible – a re-distributive component on top. In doing so the campaign pursues three more concrete objectives: (1) to reverse the trend of decreasing real wages in many European countries – and in particular in the southern and central eastern European countries; (2) to realise a re-distribution of income and wealth from capital back to labour; and (3) to reduce the wage inequalities that exist among different groups of workers as regards gender, sector and types of employment – the particular aim here is to achieve a disproportionate increase of wages for low-paid workers.

However, without the appropriate institutional underpinning the coordinated pursuit of such a more expansive and solidaristic wage policy is impossible. To this end, three basic components are required: appropriate minimum wages; all-encompassing multi-employer bargaining systems (at sectoral and/or cross-sectoral level); and strong trade unions (Schulten et al. 2017). Despite a more dynamic development of real minimum wages across Europe and, in particular, in central and eastern European countries during the last two years, their level is frequently still very low so that workers cannot make a living from what they earn and often have to rely on additional support from the state. Thus, an important element of an expansive and solidaristic wage policy is to ensure appropriate minimum wage levels – in accordance with national customs and practices – that enable workers to live in dignity with a decent standard of life and to share in society.

Since there is clear empirical evidence of a pay premium for workers whose wages are determined by collective agreements, another important institutional requirement for the pursuit of an expansive and solidaristic wage policy consists of ensuring high collective bargaining coverage through the support of multi-employer bargaining systems. The spread and strength of multi-employer bargaining depends on two factors: (1) the existence of powerful and all-encompassing bargaining parties – on both the employers' and the trade union side – that can ensure a high bargaining coverage through their organizational strength; (2) state support for multi-employer bargaining – for instance through the administrative extension of collective agreements. The latter is particularly important in those sectors in which trade union density is not sufficient to ensure high collective bargaining coverage.

Any strategy for increasing pay in Europe therefore must include two elements: the pursuit of an expansive and solidaristic wage strategy in bargaining rounds and creating the right kind of institutional framework conducive to this strategy. The latter includes above all a reversal of the current European crisis management aiming at a radical decentralization – and in some cases dismantling – of multi-employer bargaining systems and an end to the recurrent attacks on unions' capacity to act by restricting the right to strike and increasing the opportunities for non-union groups of employees to conclude company agreements.

Under the current political circumstances the implementation of such a new wage policy may sound utopian. However, the newly launched ETUC campaign for a pay rise across Europe represents an important step in taking

the traditional coordination approach one step further than customary "labour diplomacy" by essentially lobbying European institutions for a more demand-side oriented and more socially oriented crisis management – and combining this with a mobilisation across the entire movement of affiliates and the wider public for alternative policies and a counter-narrative supporting trade union strategies and objectives (Müller and Platzer 2017).

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Outlook

A feasible conceptual and institutional reform agenda for macroeconomic coordination and convergence in the euro area

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There is general agreement on one thing: the institutional underpinning of the single European currency is not fit for purpose. If that were not obvious earlier, then the specific crisis that hit the Euro Area after it had already begun to recover from the Great Recession, and the failure, since then, to resolve it effectively have rendered it abundantly clear. What is highly disputed, however, is the direction in which institutional change should proceed and, given that, the specific focus and proposals required.

This contribution shares with most of those in this volume a belief that the Euro Area needs to be reformed in the direction of a greater integration of important fields of economic policy-making. We do not propose an entirely

comprehensive reform package. The focus here is on the issue of mechanisms to achieve real and nominal convergence among the Euro Area countries. This is not everything, but it is, we argue, a *conditio sine qua non* for effective governance of the single currency. A third characteristic of this contribution is that we do not adopt an approach that asks what would be the optimal policy solutions to existing problems. Rather, we attempt to weigh demands of effective economic policy-making against the political constraints of getting reforms capable of generating noticeably better results than at present within a reasonable time-span; our approach is therefore one of conceptual and institutional incrementalism.

We briefly set out the rationale for the focus on convergence, and examine some of the recent institutional developments and likely constraints on further reform. We then set out a reform program that we believe achieves a balance between equally crucial considerations of effectiveness and feasibility.

The starting point of any therapy is diagnosis. An extremely condensed statement of what might be considered the Achilles Heel of the currency union as currently constituted is that the pro-cyclical forces within each member state are stronger than the equilibrating forces. This leads to lop-sided economic development and a build-up of imbalances that can only be resolved through periodic crisis. Thus balanced, steady growth is impossible. An important immanent pro-cyclical driving force is the real interest rate. For a given nominal interest rate set for the whole currency union by the ECB, the real interest rate in a given member state is determined by the pace of price and wage inflation. The higher the rate of economic activity or of domestic

demand, with respect to 'potential output', the faster prices and nominal wages tend to rise and the lower the real interest rate. In economies with sluggish demand growth, leading to a disinflationary or even deflationary environment, real interest rates are high. This, however, is the exact opposite of what is required to bring the economy back towards equilibrium. Diverging internal demand, prices and interest rates interact in cumulative fashion and tend to send economies onto diverging paths.

There are numerous forces acting in the opposite direction, bringing countries back on a convergent path. First there is the real exchange-rate channel. Countries with higher (lower) inflation rates suffer a loss of (enjoy a gain in) international competitiveness, which dampens (stimulates) demand. Another automatic mechanism kicks in via the built-in fiscal stabilizers: faster real and nominal growth tends to raise taxation while reducing government spending, with the opposite occurring in sluggish economies. A third factor is also primarily fiscal (but may also incorporate macro-prudential and other regulatory changes); it is the discretionary management of aggregate demand by governments to keep it broadly in line with supply. Finally, there are more direct attempts to steer the path of prices and, especially, nominal wages and thereby unit labour costs through the use of guidelines, social pacts and other measures for which we will use the generic term (nominal) "incomes policies".

Yet these countervailing forces proved to be too weak or – in the case of the third factor, discretionary policy – an at times exacerbating force. Economic developments in the Euro Area up until the crisis were accordingly characterized by divergence, most obviously manifesting themselves in the

creation of ever-larger current account imbalances. Domestic demand boomed in countries such as Greece and Spain while it was sluggish in core countries, most notably in Germany. Nominal unit labour costs and prices rose substantially faster than the ECB target in the former; in Germany nominal unit labour costs were essentially flat for much of the pre-crisis period. Current account deficits grew inexorably towards 10% of GDP (as much as 15% in Greece), while Germany accumulated ever-larger surpluses. This was reflected in a build-up of net financial liabilities in the former and net foreign assets in the latter (see Herr in this volume).

Lacking a safety valve in the form of exchange-rate adjustment, the Euro Area crisis took the form of a sudden stop in credit flows, followed by a wrenching adjustment crisis. This was made worse by the failure to rebalance based on symmetric adjustment in both deficit and surplus countries; while surplus countries have picked up only recently, the current account deficit countries embarked immediately after the crisis on austerity, demand deflation and internal devaluation. The result was a close-to deflationary overall situation, stagnant demand and output growth and an increasing dependence on a rising current account surplus of the Euro Area as a whole with the rest of the world.

Given the limited institutionalization of the Euro Area, in particular the lack of substantial cross-border fiscal transfers and the (belated and incomplete only) provision of a lender of last resort capacity, competitive differentials and macroeconomic imbalances were a "disease" that proved almost fatal for the entire project. The remedy, in a nutshell, is to strengthen the countervailing forces. The impact of the real exchange rate channel and the automatic stabilizers are, in the short-

and medium-run, not susceptible to policy influence. The former depends on import and export shares in output (and their regional structure), the latter, to a first approximation, on the size of the public sector in the economy[1]. The most promising ways to bring about balanced development and convergence are to strengthen, and improve, the interaction between national demand management and incomes policies.

Institutional reform since the crisis

The years since the outbreak of the crisis have seen substantial institutional development and redesign. Unfortunately, though, these reforms have not resolved the fundamental problem of the weakness of instruments that can be deployed to bring about convergence and thus facilitate balanced growth. Some developments – such as the creation of the European Stability Mechanism, developments in the monetary policy field (like Outright Monetary Policy (OMT)), or Banking Union – are important in their own right and may be vital in dealing with future crises (see Grabau and Joebges as well as Schuberth in this volume). They are not designed, however, to bring about the required medium-run convergence.

Worse, the rules governing national fiscal policy have been significantly tightened, primarily through the so-called Fiscal Compact. Yet this has merely intensified an undue preoccupation with (cyclically adjusted) budgets and with government debt ratios (see Priewe and Truger in this volume). The rules still fail to provide appropriate constraints on national fiscal policy for it to focus – where possible,

in combination with incomes policy – on what should be its key function in a monetary union: keeping aggregate nominal demand broadly in line with the development of productive capacity and, as a corollary, helping to reduce internal macroeconomic imbalances and inflation differentials to a minimum.

Lastly, one institutional development has been conceived with the explicit aim of limiting divergence: the Macroeconomic Imbalance Procedure (MIP). Modelled procedurally on the fiscal governance framework, this involves evaluation of the potential for macroeconomic imbalances in each member state by the European Commission via a scoreboard of relevant indicators, such as unit labour cost growth, the current account and net international investment position and various credit-related indicators. For each numerical trigger, values have been defined. Countries identified as suffering from or being at considerable risk of such imbalances are subject to more intensive, also qualitative monitoring. Corresponding recommendations are issued to member states. As under the fiscal rules, member states that persistently fail to comply with recommendations and whose imbalances continue to increase can ultimately face sanctions.

The philosophy underpinning the MIP is very much in line with the analysis of the crisis and the risks to balanced growth adumbrated above. To that extent, the introduction of the MIP marks an important step forward. However, it suffers from some serious drawbacks. First, it exists alongside fiscal rules which may well mandate countries to pursue a very different fiscal policy from that implied by the MIP. Second, the numerical values attached to the indicators in the scoreboard clearly reveal the asymmetrical nature of the exercise.

For the indicator nominal unit labour cost growth, most obviously, there is only an upper, no lower bound. The triggers with respect to the current account are (minus) 3% for deficits but 6% for surpluses. Clearly, the focus is on bringing about policy change in buoyant economies with rising current account deficits. This imparts a potentially dangerous deflationary and anti-growth bias to the whole framework.

What is also noteworthy is that some elements of the institutional framework have *not* enjoyed reform in the wake of the crisis. We consider two of them to be particularly relevant. The first is the overall framework for the coordination of economic policy established by Article 121 of the Treaty on the Functioning of the European Union (TFEU) from 2007 and particularly the Broad Economic Policy Guidelines of the Member States and the European Union (BEPGs). The second is a little-known institution, the Macroeconomic Dialogue of the EU. As these are important elements in the reform concept presented in the last section, we describe each in turn here in its current form.[2]

Long before the introduction of the Euro, Treaty provisions that go back to the Rome Treaty setting up the European Economic Community – and now set out in Article 121 TFEU – have, in principle, provided the conceptual and legal framework for economic policy coordination. Member states are to see economic policy as a matter of common interest and to ensure their coordination in the Council, with a view to achieving the broad goals of the EU set out in Article 3 of the Treaty on the European Union (TEU); these include sustainable economic growth, full employment and price stability. Moreover, the BEPGs – which involve a monitoring, reporting and policy recommendation system similar

to that of the Stability and Growth Pact (SGP) and now the MIP – provide, again in principle, the operational means to bring about a consistent macroeconomic policy-mix in the member states oriented towards these broad welfare goals. More specifically, the BEPGs have consistently insisted on the importance of wages adhering to a "golden rule", that is real wages growing in line with (medium-run) productivity and nominal wages so as to be compatible with price stability. Moreover, the BEPGs have always taken account of the interdependence and thus the required coordination of the macroeconomic policies by saying that in general – given a mix of national fiscal and incomes policies compatible with price stability – monetary policy is called upon to do as much as it can to create conditions favorable for growth and employment. From a member state point of view, this includes, if necessary, a more or less expansionary stance, and should be reflected in the Country Specific Recommendations (CSR).

However, despite numerous tweaks to the procedures, the BEPGs have in practice taken a back seat to the fiscal rules. No country has seriously been threatened with sanctions, although these are foreseen in the Treaty, for failure to adjust economic policy to bring it in line with the BEPGs.

A more recent, and even less well-known, institution is the Macroeconomic Dialogue of the EU (EUMED), established at the behest of the European Council in Cologne in 1999. It brings together top-level representatives of the social partners (European Trade Union Confederation and three employer federations), the monetary authorities (the ECB plus one non-Euro Area central bank), a "Troika" of representatives of the ECOFIN Council (among them the

president of the MED) and two representatives of the EU Commission. The goal is, while respecting the autonomy of actors, to improve mutual understanding among actors with a view to achieving a better balance between incomes policies (essentially: wage developments), monetary and fiscal policy stances.

In terms of the analysis sketched above over governance deficits and reform needs, it is obvious that the EUMED brings together the relevant actors and has the right thematic orientation: towards a consistent macroeconomic policy-mix among the three main relevant policy fields. However, located solely at EU level, it lacks both a specific orientation to the special needs of the Euro Area countries and, more fundamentally, an underpinning by representatives of national actors in each member state. For both incomes and fiscal policy, the national level is decisive. Meanwhile, until the crisis at least, the ECB was focused solely on Euro Area aggregates and had little interest in national developments. In short, it lacks the necessary clout.

A feasible reform strategy

Alongside reforms that have already occurred, two institutional developments foreseen in the so-called Five Presidents' Report on completing Europe's economic and monetary union (European Commission 2015) are also relevant here. The report proposed to set up so-called competitiveness councils in each member state. They were to have a mandate to examine competitiveness issues in each country and to make expert recommendations to national governments.

This proposal received a hostile reception, however, not least from national and European level trade unions which saw the councils as focusing one-sidedly on wage developments and threatening policy interventions in collective bargaining institutions and practices that, in many countries, are the legally autonomous responsibility of unions and employer federations. In the recommendation subsequently made by the EU Commission and accepted by the Council a change of name to "productivity boards" was accompanied by a substantial widening of thematic focus – to incorporate much broader issues determining productivity trends. At the same time, the initially foreseen competence of the boards was substantially watered down: they are now envisaged as playing a solely analytical role without the power to issue recommendations. In addition, the Five Presidents' Report foresaw the swift introduction of a Fiscal Board to serve in an advisory capacity on fiscal issues. Here, too, the remit is limited, but the institution is potentially important in bringing together independent expertise.

Meanwhile, the Committee on Constitutional Affairs of the European Parliament recently presented a blueprint for a far-reaching overhaul of the economic governance regime of the Euro Area (Rapporteur Guy Verhofstadt, European Parliament 2016). Its goal is to bring together fiscal and monetary instruments in a genuinely common European economic policy. To this end, the fiscal procedures focusing on deficits and debts, the MIP and the CSR are to be melded into a single so-called 'convergence code'. Overall responsibility will be accorded to an EU finance minister who is simultaneously one of only two vice-presidents of the EU Commission. On the basis of a collaborative procedure

between member states and European-level institutions, this finance minister will ultimately make economic policy recommendations to each member state. These recommendations will be backed up by the threat of serious sanctions. Unlike the current system of – unused – financial penalties, the sanctions envisaged, following the approach of the Five Presidents' Report, amount to a denial or withdrawal of access to European 'public goods', notably to a putative common fiscal capacity for stabilization purposes.

Lastly, the EU Commission published a 'White Paper on the Future of Europe' including five scenarios. Scenario 5 ('Doing much more together') is the most ambitious one. Regarding the macroeconomic dimension, it says: "Within the euro area, but also for those Member States wishing to join, there is much greater coordination on fiscal, social and taxation matters, as well as European supervision of financial services. Additional EU financial support is made available to boost economic development and respond to shocks at regional, sectoral and national level." This needs to be seen against the background of the Five Presidents' Report, in which a necessary precondition for setting up a macroeconomic stabilization function for the euro area is convergence towards similarly resilient national economic structures. Scenario 3 ('Those who want more do more') could also be considered relevant for the considerations that follow to the extent that the Euro Area countries are considered as a group that needs further integration without this necessarily binding the non-members.

We consider the Verhofstadt proposals to constitute a coherent set of policy proposals to address the crucial concerns facing the Euro Area. The changes would neces-

sitate quite substantial revision of the Treaties, however, involving a full ratification process by all member states. For this reason, a communitarization of economic policy on this scale does not appear to be a realistic political option at the present juncture.

Rather, in order to make progress towards the goals set by the Five Presidents' Report and the White Paper, we propose a pathway of pragmatic conceptual and institutional development that takes existing regulations and institutions as a basis. It appears politically feasible, while at least substantially improving the coordination of member state economic policies with a view to achieving the necessary convergence and reducing the potential for imbalances, tensions and crises. A more detailed exposition is in preparation (Koll/Watt 2017, see also Koll 2016). The main elements can be summarized as follows.

- The framework for the coordination of national economic policy is obtained by revitalizing the procedures in Article 121 TFEU (in conjunction with Articles 120 and 119). This means that the BEPGs play the role of key coordination instrument. Conceptually they encompass the entire macroeconomic policy mix, and thus ensure transparency and coherence in a similar way to the idea of a convergence code proposed by the European Parliament.
- Complying with the rules of the BEPGs as described above will be helpful in meeting the fiscal rules and the MIP. Nevertheless, reforming the SGP in a way conducive to macroeconomic stabilization and ensuring that the MIP operates ina symmetric way would improve the efficiency of the policy-mix in a consistent and goal-oriented manner and will be required sooner or later.

- The next element is to bring together at the level of the Euro Area macroeconomic expertise whose analyses can be put in the service of policy coordination. To this end, we propose that the Fiscal Board, already established in the wake of the Five Presidents' Report, should serve as the nucleus for an institution that is developed in a number of dimensions. Most importantly, its thematic area of competence needs to be substantially extended. Rather than focusing on budgetary issues more or less in isolation, its remit should be extended to the macroeconomic policy-mix as a whole. In other words, its focus should be the interaction between monetary, fiscal and 'incomes' policies (that is nominal wage developments, also paying regard to functional income distribution).
- Membership of the Board should be substantially increased, not only to allow for the much broader thematic reach proposed here, but also to ensure a degree of pluralism in theoretical approaches. The key task of this institution – which could be termed 'Advisory Board for Macroeconomic Convergence' – would be to produce quantitative macroeconomic scenarios for the Euro Area as a whole.
- In the current juncture, this also means thorough analysis of the continuing crisis and strategies to overcome it. These chart in a quantitative form alternative paths and these can be based on a range of different assumptions, that, however, all take account of the interactions between Euro Area monetary policies and fiscal and incomes policies at national level. In so doing, this offers a counterweight to a likely tendency of national boards (see next bullet point) to ignore the external impacts of national economic policy

decisions on other actors, and indeed to consciously rely on 'race-to-the-bottom'-type strategies that are destructive for the European economy in aggregate. As the proposed name indicates, the role of the Board is purely analytical and advisory; it does not issue recommendations.

- Corresponding National Convergence Boards would be set up. These represent an institutional development of the already agreed Productivity Boards. Their remit and main task match those of the Euro Area-level Board. They should elaborate country-specific, forward-looking quantitative scenarios. Clearly monetary policy will here take the form of an exogenous factor and the focus will be on the interaction between fiscal and incomes policies. Here, too, the role is purely analytical.
- The point of the analyses and scenarios developed by the Euro Area and national convergence boards is to provide a coherent basis, taking account of relevant macroeconomic feedback effects, for action by governments and social partners, action that is coordinated via the BEPGs. What is needed is an appropriate mediation body. Here we propose to take as a basis the European Macroeconomic Dialogue (EUMED) whose basic features, and limitations, were described above. This is because, whatever its limitations, it has the required thematic focus and brings together the decisive actors around the table.
- However, the EUMED has as its point of reference the EU as a whole. The new body needs to be tailored to the specific needs of the Euro Area and at the same time be given the necessary underpinning at national level that is currently lacking. This will require substantial development of the basic EUMED architecture along the

following lines:

- First, a Macroeconomic Dialogue must be established at the level of the Euro Area (EUROMED). A pragmatic and effective way to achieve this would be to informally extend, at least twice a year, the meetings of the Eurogroup by bringing in representatives of the peak European social partner organizations. Unlike in the EUMED where member states are only represented by a "Troika" of ECOFIN Council, this would ensure full representation (finance minister) of all the Euro Area member states.
- Second, in each member state a Macroeconomic Dialogue at National Level (MEDNAT) is to be set up, also with top-level representatives of monetary (the national central bank) and fiscal policy as well as the social partners.

- In both the EUROMED and the MEDNATs, the report of the respective convergence board serves as the point of departure for an evaluation of and a cooperative orientation of the relevant policies within the macroeconomic policy-mix.[3]
- Discussions within the different MEDs would be geared to maintaining the autonomy and independence of the various actors. Results should give guidance in formulating the final BEPGs.
- At the same time, actions and policies are framed according to agreed basic guidelines. Clearly central is the need to limit the size of both negative and positive output gaps (while seeking to expand productive potential). Nominal wages and profits should increase is a way that is consistent with balanced non-inflationary growth and,

where appropriate, they should help to correct any macroeconomic (current account) imbalances that have arisen, again in a symmetrical fashion.

- A notable benefit of this institutional enrichment and deepening is that national actors' 'ownership' of the country-specific recommendations that come out of this inclusive and consultative process is substantially greater than now. Already there is provision in the treaty for sanctions in the case of repeated failure to respect recommendations. This principle is to be retained, while at the same time more effective instruments need to be designed, along the lines of those envisaged in the Verhofstadt report (withdrawal of access to public goods).

The conceptual and institutional reforms that we have briefly set out here all take as their basis existing institutions. No changes to the treaties are initially required (although reform of the fiscal rules would be necessary at some point). The reforms would by no means solve all problems relating to economic governance but they would mark a milestone on a path towards achieving the degree of coherence and convergence that EMU requires if it is to achieve the required combination of dynamism and stability.

Notes

1. In fact coordinated steps could be taken to strengthen national automatic stabilisers (Watt 2011). Cross-border stabilization is also possible e.g. in the form of an EU unemployment insurance fund, but we do not develop this further here.
2. A more thorough treatment of both can be found in Koll 2013.

3. In the case of monetary policy in the narrow sense, at national level this is more or less a given; however national macroprudential policy from the national central bank (where appropriate in conjunction with other government agencies) can be an important tool for maintaining balanced economic developments and for correcting imbalances.

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