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We don't need no federation
What a devolved eurozone should look like

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CENTRE FOR EUROPEAN REFORM

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Summary

At the heart of the eurozone's troubles lies a fundamental contradiction. On the one hand, the economics of a monetary union requires considerable integration of policies at eurozone level, and a high degree of economic discipline at national level. On the other hand, most people in the eurozone do not want to be ruled by some kind of 'eurozone government'. They prefer national democracies – of the sort that struggle to impose sufficient discipline. This contradiction is both intellectually and politically hard to resolve.

Three key principles for an economically and politically sustainable eurozone emerge from this contradiction. First, the countries of the single currency should integrate deeply where integration is economically essential. Second, the eurozone should leave as much as possible to its member-states. Third, there are areas in which democracies may not be able to implement policies that are in the long-term interests of both the individual countries and the eurozone. In these areas, the eurozone should delegate policies to independent national bodies rather than try to enforce European rules.

These three principles suggest that banking and financial markets should be fully integrated. Financial flows across borders are a natural (and in part welcome) outcome of monetary integration. Useful financial integration, such as equity investments across borders, can help cushion the impact of economic shocks on individual member-states, as they spread the pain of such shocks across the currency union as a whole. But capital flows can be destabilising if inflows of short-term debt fuel unsustainable booms. Moreover, some banks are closely connected to their sovereigns: they may hold large stocks of their government's bonds, and the government may be called upon to bail out the banks in a severe crisis. Banks and governments are also linked to their national economies, via lending and taxes respectively. This can create a 'doom loop' of banks, governments and their regional economies, whereby the weakness of one weakens the others, in a self-reinforcing cycle. The regulation and resolution of banks, as well as the protection of depositors should be a European, not a national task, to enhance the stability of the whole monetary union. National financial

regulators should be dismantled to open the way for a truly integrated banking system.

A stable level of demand is crucially important in a monetary union, as excessively low demand can lead to regional depressions and soaring debt, destabilising the whole union in the process. The European Central Bank (ECB) has failed to maintain the necessary level of demand and inflation during the course of the eurozone crisis, and needs a stronger mandate to prevent this from happening in the future. Such a mandate should include a higher and symmetrical inflation target, as well as the explicit responsibility for maintaining an adequate level of demand. National central banks should no longer be involved in eurozone monetary policy, since they tend to politicise decisions along national lines.

Countries in the eurozone can be subject to runs on their government bonds, similar to a bank run. For banks, the solution has long been to establish a lender of last resort that prevents a crisis of bank liquidity from spiralling into one of insolvency. Eurozone governments need a comparable lender of last resort, and the ECB rightly took on that role by announcing its unlimited bond-buying programme ('OMT') in the summer of 2012.

When countries give up independent monetary policies, they need to use alternative macroeconomic stabilisation tools such as fiscal and regulatory policies, lest cyclical swings become destabilising. In democracies, fiscal and regulatory policies do not always act in a strongly counter-cyclical fashion. Fiscal rules are one way to tie governments' hands and enforce counter-cyclical policies but have major shortcomings. They tend to be inflexible and therefore cannot deal with the complexity of fiscal policy-making in a monetary union. Furthermore, fiscal rules – particularly if imposed from the outside – are an inadequate replacement for national institutions, whose decisions citizens and politicians are generally willing to accept.

The responsibility for ensuring that fiscal policy is robustly counter-cyclical and debt sustainable should be given to independent national bodies. Ideally, these institutions should have a macroeconomic mind-set, high credibility in the eyes of the public, and a strong political and constitutional mandate to guard both macroeconomic stability and debt sustainability. National central banks – without a real function since the introduction of the euro – are ideally placed

to take on such a role. What is more, the implicit mandate of national central banks – to ensure macroeconomic stability – would not need changing, just the tools.

Macroprudential regulation is the part of financial regulation that looks beyond individual banks to the system as a whole, and it serves three purposes: it guards the stability of the entire financial system; it helps to stem destabilising capital flows across borders; and it acts counter-cyclically to even out swings in national business cycles. Therefore, macroprudential policy should be the joint responsibility of national central banks in their new role, suggested above, and the ECB.

Structural reforms should remain in the hands of national democracies. While it is true that the eurozone as a whole has an interest in good structural policies in each member-state, the economic case for centralisation is weaker than the political need for such policies to remain under national democratic control. If there is a role for the European Union, it is within its usual remit: providing an outside assessment of policies, and using the single market, consumer protection and competition tools to break up vested interests.

Introduction

In an ideal world, the eurozone would have a financial, fiscal and political union. But the eurozone collects a diverse group of nation-states with different political and economic traditions. As much as the economic case for closer integration is strong, the political arguments against it are compelling: most Europeans want co-operation between strong democratic nation-states, not a technocratic central authority with weak democratic legitimacy. In the absence of a European demos, integration that would, in theory, make the eurozone economy more stable might be politically unsustainable, and hence unworkable.

The politics and the economics of the eurozone thus seem irreconcilably opposed. And yet, there may be a viable European middle ground as long as eurozone policy-makers focus on those areas where integration is crucial for the stability of the eurozone, leaving as much as possible to the nation-state, in which democracy, solidarity and accountability are stronger. This middle ground is small, however.

Some of the reforms that eurozone policy-makers have piloted through in the past few years are worthy of praise. The European Central Bank (ECB) has made itself the lender of last resort to governments which is essential to the functioning of the eurozone – a bold move that was backed by the German government. The banking union, steered by an increasingly powerful ECB, is a big step forward in an area where European integration is crucial for economic stability. And the nascent capital markets union, which may help to make the eurozone more resilient, is one of the European Commission's top priorities, although it will take a long time to construct. Last June's 'five presidents' report' on eurozone governance rightly called for the banking union to be completed, including by creating a big common backstop for banking resolution and common deposit insurance; and for the capital markets union to move forward as quickly as possible.[1]

In other areas, however, the five presidents set the wrong priorities. They want to strengthen budget rules that emphasise debt reduction, whereas fiscal policies that stabilise the economy throughout the

1: Jean-Claude Juncker, Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz, 'Completing Europe's Economic and Monetary Union', European Commission, June 22nd 2015. See also Christian Odendahl, 'The eurozone's 'five presidents' report': An assessment', CER insight, June 22nd 2015.

business cycle ('counter-cyclical' policy) should be at the heart of eurozone reforms in this area. Fiscal rules are also ill-suited for the complexity of fiscal policy-making in a monetary union. The common eurozone fiscal stabilisation function suggested in the report, while a useful addition, would not be enough.

The five presidents also want the eurozone to co-ordinate structural policies so that they converge towards common eurozone standards. However, structural reforms are inherently political decisions: they involve complex choices, local problem-solving, and bargaining processes within societies which national democracies, their imperfections notwithstanding, might still be best-placed to deliver.

What the five presidents' report leaves out entirely is the role of the ECB as the guardian of stable inflation and adequate demand in the eurozone. Stable overall demand is more important in a monetary union than if each country had its own currency. In a monetary union, individual countries need to stabilise their economies with arguably weaker levers such as fiscal policy. They will find that harder to accomplish when overall eurozone demand is inadequate. The ECB has failed to maintain inflation close to its target and let demand growth fall by half after the crisis. In the future, the ECB needs to be more active to pre-empt shortfalls in demand. This requires a stronger, more aggressive mandate.

This policy brief first analyses the economic problems that are inherent in a monetary union, in order to assess what economic policies should be determined at the eurozone level. Second, it considers the political constraints that prevent such centralisation of policy, and whether nation-states, democracy and economic and monetary integration are compatible at all. It then outlines a eurozone architecture that balances economic and political constraints. This plan would not only help to prevent future economic crises but also to overcome the eurozone's current problems. It would lead to fiscal and monetary policies that stabilise demand in the eurozone; and it would ensure the lowest level of public debt – in the absence of debt restructuring – that Europe could hope for.

Chapter 1

The eurozone's fundamental economic problems

The macroeconomics of a monetary union is a highly complex topic, and it may be helpful to go back to first principles before reconstructing eurozone policy from the ground up. A good starting point is the business cycle, a fluctuation in economic activity that governments and central banks need to counter-act, lest economic downturns or upturns become self-reinforcing. The global financial cycle – the cyclical flow of funds across borders – often reinforces the business cycle by fuelling credit booms as capital is sucked in from abroad, and deepening downturns as foreign capital is suddenly withdrawn. Stabilisation policy is therefore crucial to a country's prosperity, and the main tool for stabilising an economy is monetary policy.

When a country joins a monetary union, it gives up a monetary policy stance that is tailored to its needs, that is, the level of interest rates and money supply that is appropriate for its economy. The resulting common policy is of the one-size-fits-none variety. Booming regions, with high inflation, have the lowest real interest rate in the monetary union, reinforcing the boom; countries in economic difficulties, with falling wages and low inflation, have the highest real interest rates, further weakening their economies.[2] Other, and arguably weaker, policy levers than monetary policy – fiscal and regulatory policy – therefore need to stabilise demand, the economic cycle and capital flows in countries of a monetary union.

Fiscal policy comprises automatic changes in spending – the 'automatic stabilisers', such as unemployment benefits that automatically increase during a recession – and discretionary changes in taxes and spending, such as a stimulus programme. To counteract the fluctuations of their economies, member-states' fiscal policies need to be strongly counter-cyclical: very expansionary during

2: Real interest rates ultimately matter for investment and consumption decisions because they represent the real cost of borrowing. If nominal interest rates are 2 per cent but inflation is also 2 per cent, the cost of borrowing is zero because everything will have become more expensive over the year. Since inflation rates differ across countries that are at different points of the business cycle, real interest rates can, and usually are, very different across countries in a monetary union. See Christian Odendahl, 'The eurozone's real interest rate problem', CER Insight, July 8th 2014.

recessions, and very restrictive during boom times. A country with its own monetary policy also benefits from counter-cyclical fiscal policy – counter-cyclical policy has been shown to contribute to growth by making the economy more stable.[3] But for members of the eurozone, strongly counter-cyclical policies are essential since they cannot rely upon tailored monetary policy.

For its part, regulatory policy is needed to curb lending booms in and capital inflows into overheating financial systems – otherwise known as macroprudential regulation.[4] Such regulation is focused mostly on banks. During a credit boom, it could require banks to fund new lending with more of their own capital rather than by borrowing more – or regulators might mandate large down-payments on house purchases to deflate housing bubbles. Every country, inside or outside a monetary union, should apply macroprudential regulation to enhance the stability of its financial system. However, countries in the eurozone need to apply it even more strongly, for three reasons. First, avoiding crises is even more important to eurozone countries since there is no tailored monetary policy to help a post-crisis economy recover. Second, macroprudential regulation can help fiscal policy to even out the business cycle, by curbing financial booms in overheating countries. Third, cross-border capital flows are more intense inside a monetary union and can drive destabilising local debt-driven booms. Since countries in the EU cannot prevent outside capital from flowing in, both sides – the country receiving such flows, and the countries from which the capital flows originate – need to put on the regulatory brakes if such flows are deemed unsustainable.

Before the crisis, these two levers – fiscal policy and macroprudential regulation – were not used enough, and in many cases, not at all. Some countries, notably Spain, ran budget surpluses and used regulatory policies to curb housing booms, but these efforts were insufficient. Other countries did nothing, using low interest rates to paper over underlying economic weaknesses, or even to feed booms. Ironically, Germany's decision in the mid-2000s to break Europe's fiscal deficit rules was appropriate fiscal policy. In fact, Germany should have done even more to boost demand during that time.

When fiscal and regulatory policies are not counter-cyclical enough, the resulting booms (or downturns) can lead to severe misalignments of prices, wages, current accounts and debt. The following misalignments are typical.

3: International Monetary Fund, 'Can fiscal policy stabilize output', Fiscal Monitor, Chapter 2, April 2015.

4: Microprudential regulation is the regulation of a single bank according to its balance sheet, risk profile etc. Macroprudential regulation considers the stability of the whole financial system, and macroprudential regulators will impose restrictions on all banks if there are dangers to overall stability.

If an economy's growth is based on credit expansion and capital inflows, the result is typically strongly increasing private consumption and wages. When the boom ends, the economy will be robbed of these sources of demand, and will be left with relatively high wages and debt levels, and without an exchange rate to help ease the necessary adjustment. Such a loss in price 'competitiveness' occurred in countries such as Spain, but it is not a root cause of the crisis. It is mostly a symptom of insufficiently counter-cyclical policies. The result is falling wages and deflation, as well as high unemployment.

Likewise, if a country goes through a long downturn, wages tend to be lowered too much, leading to even weaker demand, low inflation, high real interest rates and weak investment. Without a monetary stimulus to break this cycle, the economy turns to foreign demand, often from elsewhere inside the monetary union, and runs trade surpluses (which must be matched by trade deficits elsewhere). Trade surpluses represent a capital export, which flows into countries with deficits, leading them to further 'live beyond their means', fuelling the build-up of debt and instability elsewhere in the eurozone.

Those are the reasons why eurozone member-states should run strongly counter-cyclical fiscal and regulatory policies. But there are four more economic issues to consider when designing eurozone architecture from first principles.

First, if economies are closely interlinked, spill-overs between countries are stronger. In a national monetary union, such as the US or Germany, these linkages are very strong. If one region is hit by a shock, losses are spread out over the whole country. Businesses are often owned by investors from outside the affected region, meaning the income losses are not concentrated in the region itself.[5] This is referred to as 'private risk-sharing'. In a less tightly integrated union, such as the eurozone, these linkages are weaker. Two policy implications follow: the eurozone needs to foster these private linkages; and in their absence, stronger counter-cyclical fiscal and regulatory policies are needed.

The eurozone's problem is that financial transactions between countries are largely conducted between banks, and to a much lesser extent between participants in capital markets, especially equity markets. This is a double-edged sword. Banks could help to absorb shocks, if their assets and liabilities were distributed across the eurozone. This would spread the pain across the union, and help to avoid a regional credit

5: This stabilisation via private capital markets, especially equity markets, is very important. In fact, for the US, it is estimated to be twice as important as regional stabilisation via fiscal policy and transfers; see Mathias Hoffmann and Bent E. Sørensen, 'Don't expect too much from EZ fiscal union – and complete the unfinished integration of European capital markets!', VoxEU.org, November 9th, 2012. For Germany, see Ralf Hepp and Jürgen von Hagen, 'Interstate risk sharing in Germany: 1970-2006', Oxford Economic Papers, 2013.

crunch that could slow down a region's recovery. But banks that are highly leveraged and rely on short-term funding tend to amplify the financial cycle that inflates credit bubbles and leads to busts. Banks could then drag the regional economy and national governments down with them. The connection between countries via banks also encourages the eurozone to favour government bailouts over debt restructurings. Eurozone government bailouts also rescue that government's private creditors – largely banks across Europe. This was arguably the most important reason why the German and the French governments bailed out the Greek government and its creditors in 2010: to protect the stability of Europe's financial system.

There is another problem with eurozone banks – most banks are closely connected to their sovereigns: they may hold large stocks of their government's bonds, and the government may be called upon to bail out the banks in a severe crisis. Banks and governments are also linked to their national economies, via lending and taxes respectively. This creates a 'doom loop' of banks, governments and their regional economies, where the weakness of one weakens the others, in a self-reinforcing cycle.[6] This doom loop also impairs the transmission of monetary policy to the economy, since struggling banks cannot pass on lower funding costs from the ECB to consumers and businesses.

Spill-overs between eurozone countries also mean that one member-state's policies affect others. This matters because a country might not have the right incentives to pursue policies that are in the common eurozone interest. For example, countries that do not want to stabilise their business cycle by means of fiscal policies can free-ride on those that do. They might also run up debt, knowing that the consequences will have to be resolved by the next government, or other eurozone countries.

The second economic issue to consider is that one government's debt matters for the eurozone as a whole. If enough investors believe that a government's debt burden is unsustainable – or even if they just believe that others believe that this is the case – they will run for the exits: sell their government bonds, drive up that government's borrowing costs, and start a spiral that leads to a government becoming insolvent. It is a phenomenon very similar to that of a bank run.[7] Such a 'government run' will raise doubts about whether the country in question might leave the euro. The possibility of exit is

6: This dynamic is also present in countries that are not part of a monetary union, for example in Iceland in the financial crisis of 2007-08. The absence of tailored monetary policy and an exchange rate, however, makes adjustments to such shocks much harder – not least because it interacts with the next point, the lender of last resort to governments.

7: Paul De Grauwe was the most vocal commentator on the risks of government runs in the eurozone early in the crisis. Paul De Grauwe, 'Governance of a fragile eurozone', CEPS, May 2011.

highly destabilising: investors will seek a risk premium, raising interest rates. Households will first reduce consumption to preserve their euro deposits, and then scramble to take them out of the banks as the run develops. The result is economic and financial collapse unless the same government that is suffering from a run can step in boldly to preserve the system – which it cannot.

A 'government run' seldom arises in a country with its own currency. The reason is that the central bank – which is part of the state, broadly defined – can (and will) print money to finance the government if investors will not. Of course, there is a risk that if the central bank has to support an insolvent state, investors lose faith in the central bank's ability to contain inflation, and hence in the currency altogether. But as long as there is no doubt that the central bank in question can contain inflation, as is currently the case in all European countries including the eurozone, such a lender of last resort will prevent runs on government bonds.

In the eurozone, nation-states are responsible for fiscal policy, and it is not immediately obvious that the ECB can and should support a sovereign as a lender of last resort: a government might decide to free-ride on the ECB's implicit guarantee against runs, and borrow too much. This 'moral hazard' argument is not without its merits. However, governments that intentionally over-borrow might find that the ECB refuses to act as lender of last resort unless the country also signs up to a rescue programme. Such a programme, as Greece and others can attest to, is a thoroughly unattractive prospect, which weakens moral hazard considerably.

As the euro crisis has shown, without a lender of last resort to governments, a monetary union is inherently unstable – because a 'government run' might prompt a country to leave the euro, as seemed possible at the height of the eurozone crisis.[8] A lender of last resort is therefore crucial to the eurozone's stability.

A third economic issue to consider when designing eurozone architecture from first principles is labour migration and wage flexibility. If a country is struggling, its workers migrate to other countries in search for jobs. They also tend to accept lower wages when unemployment is high. In the past, the conventional wisdom was that labour mobility and flexible wages were key ingredients in a

8: Ana-Maria Fuertes, Elena Kalotychou and Orkun Saka, 'How did the ECB save the eurozone without spending a single euro?', VoxEU, March 26th 2015.

stable monetary union, as both were thought to allow economies to cope with shocks in the absence of an exchange rate – wages would adjust more rapidly, allowing countries to regain competitiveness, and unemployment would be lower than would otherwise be the case.

Recently, however, economists have realised that labour market flexibility has its downsides. Labour mobility, while beneficial to the country that migrants move to and to the migrants themselves, may make it harder for the originating country to escape a slump, as workers take their purchasing power with them.[9] Falling wages have ambiguous effects, too. On the one hand, they may correct prior exuberance in wages and make businesses more competitive, which can help the economy recover through stronger exports; but on the other, they reduce household consumption.[10]

The final economic aspect to consider is the overall level of demand. In the eurozone, each country cannot rely on its own, tailored monetary policy to ensure a stable level of demand, and so needs to revert to the weaker tools of fiscal and regulatory policies. As a consequence, demand will vary more in countries of a monetary union than if each country had its own currency and monetary policy. If on top of that, the central bank of a monetary union lets demand slip to inadequate levels, or lets it increase too quickly, the effects will be amplified. In periods when inflation in the eurozone is above target, booming countries will boom more than they would if they controlled their own monetary policy, setting them up for a painful bust. When inflation is below target, struggling countries will suffer more, and debt levels become harder to service. A deflationary monetary union can also be inherently unstable. The pre-war gold standard in Europe, which was in place from 1880-1914, provides a strong lesson in this regard: in deflationary periods, countries were forced to leave the gold standard as membership became too costly to maintain as debt burdens soared.[11]

It is therefore of the utmost importance that the eurozone's aggregate demand is kept as stable as possible. Banking regulators must therefore forcefully counter the build-up of debt and financial risk, which often precedes severe shortfalls in demand, through regulatory policies. And the ECB needs a mandate that allows it to be as aggressive as possible to counter demand shortfalls when a crisis does happen.

9: Emmanuel Farhi and Iván Werning, 'Labor mobility within currency unions', NBER Working Paper, May 2014.
10: Jordi Galí and Tommaso Monacelli, 'Understanding the gains from wage flexibility: The exchange rate connection', CEPR Discussion Paper, February 2014.
11: Marc Flandreau, Jacques Le Cacheux and Frédéric Zumer, 'Stabiliy without a pact? Lessons from the European gold standard, 1880-1914', Economic Policy, April 1998.

After crises such as the one which engulfed the eurozone after 2008, the shortfall in demand can be so severe that the central bank struggles to effectively stimulate the economy. In such instances, finance ministers need to weigh in to support demand through fiscal expansion. A monetary union therefore needs a mechanism to co-ordinate counter-cyclical fiscal policy at the level of the entire eurozone in times of severe recession.

Chapter 2

The eurozone's political trilemma

The economic analysis so far leads to one conclusion: that the eurozone needs a considerable degree of joint policy-making, as well as disciplined counter-cyclical fiscal and regulatory policies at the national level. The eurozone's politics, however, point to another conclusion – that as much as possible should be left to the democratic nation-state. Dani Rodrik has framed the political conflicts inherent in economic integration as a "trilemma", in which only two of three objectives may be pursued simultaneously. Rodrik's trilemma is this: countries cannot pursue democracy, national self-determination and globalisation at the same time; one has to give.[12]

The reason for this trilemma is that globalisation – that is, rapid growth in trade, as well as cross-border capital and labour flows – requires countries to adopt common policies such as regulation that governs consumer safety or labour standards. Therefore, the democratic nation-state cannot simply tailor policies to domestic needs and preferences – a process which threatens democracy at the national level. To tackle this trilemma governments have three choices. First, policy-making could move one level up, to a supranational democracy, with countries ceding national self-determination but preserving democracy and globalisation. Second, nation-states can act in ways that violate electorates' preferences in order to make their policies compatible with a globalised world. Or third, governments can limit the flow of goods, capital and people across their borders, and so preserve democracy at the level of the nation-state.

The eurozone is on the horns of Rodrik's trilemma. The EU is a regional form of high-intensity globalisation: a single market, common regulation, combined with, for some, a common currency. As a result, some policies – external trade agreements and some regulations, for example – are entirely decided at the EU level. In others, such as fiscal

12: Dani Rodrik, 'The future of European democracy', Institute of Advanced Studies, December 2014. The argument is presented in depth in Dani Rodrik, 'The globalization paradox: democracy and the future of the world economy', W. W. Norton & Company, February 2011. Another interesting discussion of the trilemma in the context of the eurozone is provided in Kevin O'Rourke, 'A tale of two trilemmas', Trinity College Dublin, March 2011.

policy and some financial regulation, membership of the euro demands considerable discipline, which national democracies may not be able to maintain. History serves to remind how powerful these political forces can be: many currency unions and fixed exchange rate regimes have broken down in the past because the price in terms of unemployment and lost output proved too high to bear for national governments. Britain's withdrawal from the European Exchange Rate Mechanism (ERM) in 1992 is just one of many examples.

Nor is there a European demos and democratic polity that can legitimately forge common European policies at supranational level. Instead, the eurozone is dominated by powerful national governments that more often than not are forced to ignore their electorates' wishes. To a large degree the eurozone has therefore resolved Rodrik's trilemma in the following way: national governments acted to prevent the break-up of the euro, at the cost of democracy, resulting in a form of 'executive federalism'.[13] Examples are the establishment of common bailout facilities against the wishes of voters in creditor countries, and strict austerity and adjustment programmes in debtor countries.

However, the eurozone is also different from the world at large. There are common institutions that could form the basis of a European democracy, such as the European Commission, the European Parliament, the Euro Group and many other forums for political dialogue. Supranational integration is therefore possible in Europe to a degree that would be impossible at the global level.

Moreover, the trilemma does not apply equally to all areas of policy-making. National democracies will find it more difficult to give up control over policies with severe distributional consequences – for example labour market policies or taxation – than control over more technical issues.[14] If possible, eurozone integration should focus on policy areas where member-states have similar preferences, and where the desire for national democratic control is less pronounced.

The challenge for the eurozone is therefore to find a midpoint between the three prongs of Rodrik's trilemma – between the common policies and national discipline needed to make the euro work, given the economic forces at play; and the need to preserve as much power as possible at the level of national democracies. Does such a midpoint exist?

13: See Ben Crum, 'Saving the euro at the cost of democracy', Journal of Common Market Studies, April 2013.
14: See Francesco Nicoli, 'Legitimacy, democracy, and the future of European integration', in 'Europe's crisis: the conflict-theoretical perspective', University of Freiburg, 2015.

Chapter 3

Squaring the trilemma

The first step towards finding such a midpoint is to define areas where common policies are economically essential. The eurozone's biggest economic problems are its reliance on cross-border bank lending, banks' close links to national governments, self-fulfilling runs on government bonds, and weak aggregate demand. It is in these four areas that the need for common eurozone action is most pressing.

The banking union, first agreed upon in June 2012 and in the process of implementation, has already centralised the regulation and supervision of eurozone banks (the Single Supervisory Mechanism, or SSM) and, in part, their resolution in times of crisis (the Single Resolution Mechanism, or SRM).[15] The groundwork for a eurozone banking system that cushions rather than reinforces economic shocks has therefore been laid.

But the banking union remains incomplete. The resolution of banks still remains untested in case of a severe eurozone-wide crisis, and would have to involve complex coordination with national authorities. Some 'constructive ambiguity' in the procedure of resolution is legitimate – after all, most systemic crises are unique events for which procedures will need to be changed and ad hoc decisions taken. But for a truly European banking system, full resolution powers should be given to a European authority that is independent of national governments, even in times of crises.

Likewise, the €55 billion target for the banks' common European resolution fund (SRF) is not enough: during the recent financial crisis, Germany alone had to inject €29 billion into its banks, and provide guarantees on the order of €174 billion. For it to be credible, such a resolution fund needs a credit line from a common European institution, such as the eurozone's main bailout fund, the European Stability Mechanism (ESM).[16]

15: An overview of the genesis of the banking union is provided in Nicolas Véron, 'Europe's radical banking union', Bruegel, May 6th, 2015.
16: The IMF's new chief economist has written about the need for a common European backstop. Maurice Obstfeld, 'Finance at centre stage: some lessons of the euro crisis', European Commission, April 2013.

One might argue that, due to the new rules in the Bank Recovery and Resolution Directive (BRRD), owners and creditors of banks will now be 'bailed in' and pay for the resolution of a failed bank, which will help to avoid costly public bail-outs. However, in a systemic crisis, it is hard to imagine policy-makers following these rules to the letter. Nor should they. Sometimes the best use of public money is to rescue the banking system, however unfair that may seem at the time. If the common European institutions cannot handle the resolution of banks in a severe, systemic crisis, national governments may again be called upon to rescue their national banking systems.

But the eurozone must also tackle how banks tie themselves to their home government. Regulators should move ahead with decoupling banks from their governments, by restricting the assets that banks are allowed or encouraged to hold. For example, banks should be given limits on how many home government bonds they are allowed to hold. Ideally, regulators should make banks spread their lending to both governments and the private sector across the eurozone as a whole.

The final aspect of a completed banking union concerns deposits. Common deposit insurance is needed, in order to ensure that the safety of bank deposits in a country does not depend on the solvency of its government. Although the eurozone currently lacks common deposit insurance, a number of other institutions and procedures act as a partial substitute, and may well be successful, such as the tighter regulation of banks, the BRRD, the provision of emergency liquidity to banks by the ECB, and the political commitment by policy-makers across the eurozone to protect depositors lest the uncertainty over deposits spreads to other countries. But once regulation, supervision and resolution of banks have been fully moved to the European level, deposit insurance should become a European matter, too.

Policy-makers should also push ahead more urgently with the capital markets union (CMU), currently under construction. As discussed above, capital markets can act as a stabiliser, spreading the pain across the member-states of the eurozone in the event of an economic shock. Truly integrated capital markets would make the eurozone more resilient, as the five presidents' report rightly points out. The recently unveiled action plan on the CMU makes sensible proposals, such as common standards for securitised assets and covered bonds, simpler rules for smaller businesses to make it easier for them to tap

capital market funding, and more cross-border competition in retail investment markets. But the eurozone might need to take further steps beyond the action plan, especially in equity markets, to make faster progress on the integration of its capital markets.

The lender-of-last-resort function of the ECB is highly controversial, despite the fact that the European Court of Justice ruled that it was legal in June 2015.[17] Many Germans remain unconvinced that such a function is needed, and fear free-riding by less fiscally conservative member-states. However, the ECB's outright monetary transactions (OMT) programme, which arrested bond market panic in 2012, clearly shows the importance of such a lender of last resort. Does it need to be codified in the treaties and the ECB's mandate? Purists may argue that it should but the markets do not seem to agree. ECB president Mario Draghi's promise "to do whatever it takes" – politically backed by the governments of Germany and France – seems to have been sufficient to establish the ECB as the de facto lender of last resort. Given the risk of free-riding, some ambiguity may even be helpful: member-states may be less disciplined if they know for sure that the ECB will ride to the rescue.

Aggregate demand

The final problem that needs eurozone-level policy-making is the fluctuation of aggregate demand. As noted above, excessively low levels of eurozone aggregate demand and inflation condemn the weakest regions to severe recessions, lead to soaring debt burdens and destabilise the whole monetary union; excessive demand on the other hand opens the way for destabilising booms in strong regions. This is why keeping demand stable is even more important in a monetary union than in countries with their own monetary authority. The ECB is tasked with maintaining price stability, which is another way of saying that it must keep demand growing at a sustainable rate: excessively low demand would imply too-low inflation rates, and high demand would drive prices up too fast.

The ECB's mandate seems sufficient for normal times – so long as financial and macroprudential regulation ensure that financial risks and the increase in debt are better managed than they were in the run-up to the crisis. After a financial crisis, however, the ECB may find it difficult

17: The European Court of Justice has recently ruled that the OMT is within the bounds of the treaties that govern the ECB. The German constitutional court may still try to undermine the OMT, for example by forbidding the German Bundesbank to participate, but that is not enough to undermine the political promise "to do whatever it takes", which is what matters to markets. See Christian Odendahl, 'The ECB is not the German central bank', CER Insight, December 2nd, 2014.

to keep demand stable without a change to its mandate. Before 2008, the ECB kept nominal GDP, a measure of demand, growing at roughly 4 per cent a year, but since then it has risen by a measly 2 per cent annually. The result is that inflation has fallen significantly below target (see charts).

Chart 1: Aggregate demand growth, before and after the crisis

Source: Eurostat, Haver
Note: Nominal GDP is GDP at current prices, a measure of how much has been spent in an economy, and therefore a measure of demand.

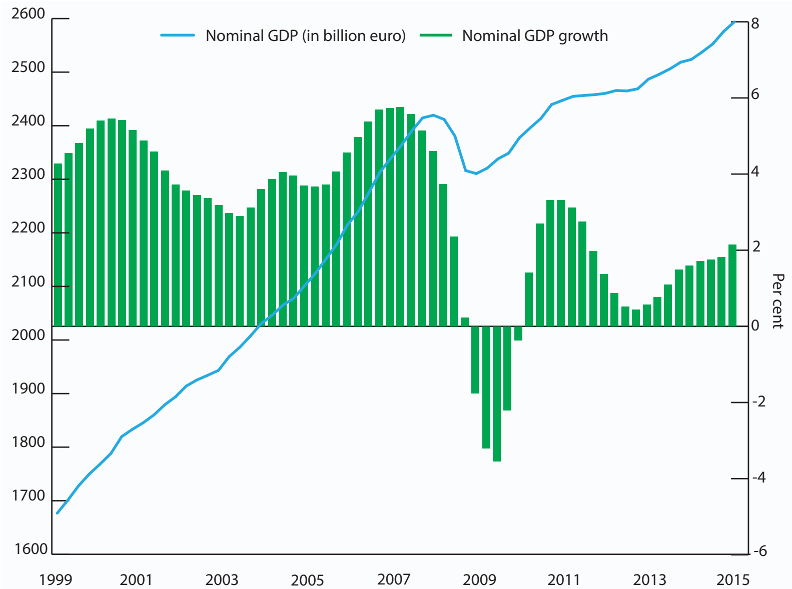
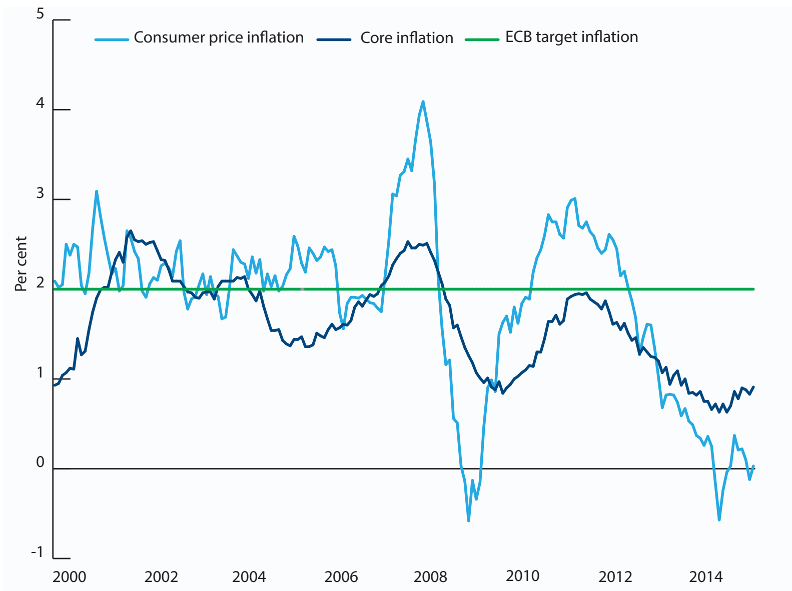


Chart 2: Inflation and core inflation in the eurozone

Source: Eurostat, Haver
Note: The consumer price inflation (HICP) for the eurozone. Core inflation measures HICP without energy and unprocessed food, two very volatile (and in the case of energy, globally-determined) prices.



Several reforms are needed to help the eurozone avoid such shortfalls in demand. First, the ECB, as the new financial regulator, should be vigilant about the build-up of financial risk and debt that usually precedes severe crises. The ECB has some tools to help prevent these risks from emerging, but it should be given more tools, especially in macroprudential regulation, to counter regional booms. Whether strict macroprudential policies in the eurozone will be enough to avoid financial crises in the future is uncertain, given that such regulation is a relatively recent invention and the financial system highly globalised.

Second, the ECB should have more tools at its disposal to fight such a shortfall. The ECB can always 'print money' and bring it into circulation in an attempt to bolster demand and drive up prices. But the ECB delayed 'quantitative easing' (QE) until inflation (and inflation expectations) had fallen far too low. Ideally, therefore, the ECB should be given a more robust and activist mandate to manage demand.

This mandate should include:

★ A higher inflation target of 3 per cent so that interest rates can be lowered more in the event of a crisis.[18]

★ An explicit commitment that this target be symmetrical, so that undershooting and overshooting the target are of equal concern.

★ A provision to take overall demand into account, rather than just inflation. In 2011, for example, inflation rose but demand was weak – and the ECB made the wrong decision to raise interest rates, which weakened demand further. In such a situation, preference should not be given to inflation.[19]

★ The explicit backing for the ECB to purchase riskier assets than government bonds – even if that implies potential losses for the central bank – in order to give a stronger stimulus to new lending by private financial institutions and to economic activity.

Finally, fiscal policy must support the efforts of the ECB to stabilise demand in case of a severe recession. The eurozone should consider building its own counter-cyclical spending capacity. The five presidents' report aims to establish a 'stabilisation function' which contains money to be invested in eurozone member-states: expenditure would be

18: When inflation is higher, interest rates will also be higher. A higher inflation target means interest rates have a longer way to go down before they hit zero (which is the lower bound on interest rates).

19: For the pros and cons of a more demand-focused target for the ECB, see Wolfgang Lechthaler, Claire Reicher and Mewael Tesfaselassie, 'Is nominal GDP targeting a suitable tool for the ECB's monetary policy?', European Parliament, September 2015.

held back in good times, so as to be more plentiful in downturns. A more radical approach would be to give the ECB limited fiscal powers to make temporary fiscal transfers to households, financed by issuing money, as part of its monetary policy toolbox.[20]

If the ECB, the SSM, and the SRM were given such wide-ranging powers, it is doubtful that national central banks and national financial regulators would still be needed. National financial regulators tend to favour narrow national interests over the stability of the eurozone's financial system as a whole. Moreover, supervisory practices and standards differ across countries, and institutional inertia makes harmonisation difficult. The SSM is designed to ensure that such national considerations play as limited a role as possible. National financial regulators should therefore be dismantled.

For their part, national central banks have unduly politicised monetary policy in the eurozone, at times pursuing their perceived national interest rather than the common European interest. If national central banks did not exist, monetary policy would be less politicised, and would be set for the benefit of the eurozone as a whole rather than for the benefit of particular member-states. The threat of an exit from the euro – one of the most destabilising forces in a monetary union as the crisis has shown – would also be lowered without national central banks because a government willing to exit the single currency would lack the infrastructure to do so. National central banks should therefore no longer be involved in eurozone monetary policy.

The main policies and institutions that need to be at eurozone level are a complete banking union, strongly integrated capital markets, a fully-fledged lender of last resort and macroeconomic policies focused on delivering an adequate level of demand. The policy brief now attempts to square the next branch in Rodrik's trilemma by identifying areas where national policy-making is appropriate but where democratic decisions can be damaging.

20: This proposal, sometimes called "quantitative easing for the people", is described in more detail in Mark Blyth and Eric Lonergan, 'Print less but transfer more', Foreign Affairs, September/October 2014. Essentially, it is a government tax cut/fiscal grant for every household, financed by the central bank. This proposal is not the same as monetary financing that could lead to hyperinflation: the central bank would not be financing an insolvent government, but stimulating the economy by other means.

Chapter 4

Policy delegation rather than integration

As discussed above, counter-cyclical policy is required to maintain the stability of national economies in a currency union. Eurozone governments did pursue counter-cyclical policies in the run-up to the euro's launch, in order to fulfil the criteria for joining the single currency, but fell back into old habits after the currency was introduced.[21] Governments must win elections and therefore tend to shy away from running strongly counter-cyclical policies in boom times – despite the fact that it would be in the longer-term national interest to do so.

Short-sighted fiscal policy can lead to excessive levels of public debt, especially in a monetary union. In part this is because governments tend not to save enough in good times, whether or not they are participants in a monetary union. But members of a monetary union have an additional problem: once bad times hit, they find it even harder than governments with their own currencies to cut spending or raise taxes and thereby reduce debt levels. Public spending cuts and tax increases in a downturn are pro-cyclical, reducing demand, and cannot easily be offset by an easing of monetary policy in a currency union. Such a policy reinforces the downturn, makes the economy contract and causes debt levels to rise (relative to falling national income). Indeed, the debt burden is bound to increase during bad times, no matter what the government does.[22]

21: See Agustin Benetrix and Philip Lane, 'Fiscal cyclicality and EMU', IIIS Discussion Paper, July 2012. Chile is a rare example of a democratic country running strongly counter-cyclical fiscal policy. See Eric Parrado and Andrés Velasco, 'Fiscal policy management: the experience of Chile', FLAR Papers and Proceedings, December 2013; and Jeffrey Frankel, 'A solution to fiscal procyclicality: The structural budget institutions pioneered by Chile', NBER Working Paper, April 2011.

22: See Luc Eyraud and Anke Weber, 'The challenge of debt reduction during fiscal consolidation', IMF Working Paper, March 2013; and Bradford DeLong and Lawrence Summers, 'Fiscal policy in a depressed economy', Brookings Paper on Economic Activity, March 2012.

The aim of this section is to find an institutional arrangement for the eurozone that provides for the following:

★ Strongly counter-cyclical fiscal policy;

★ Stable public debt;

★ Political accountability to national parliaments and the public.

One such institutional arrangement is fiscal rules. The five presidents' report aims to strengthen the eurozone's rules-based framework for fiscal policy-making, which after recent reforms rightly allows for more counter-cyclical policies. However, the problem still remains that these rules were reformed with debt reduction in mind – a result of interpreting the current crisis as mostly one of public debt. Counter-cyclical policy, which is the real issue that should concern policy-makers, was an afterthought.

There are two further problems with using rules to constrain fiscal policy-making. First, it is nearly impossible to codify into law the complexities of fiscal policy-making, especially in the eurozone. For example, the appropriate fiscal stance of a country depends on the position of its economy in the business cycle, the determination of which is an art rather than a science; on the stance of monetary policy, which in turn depends on the business cycles of all other eurozone countries; and on wages and prices in the economy in question, relative to the average in the monetary union.

The expansionary or contractionary impact of fiscal policy is also affected by the composition of spending and tax changes. After all, the fiscal multiplier (see box) is not a cosmic constant but varies according to differing economic circumstances and between different types of spending. Tax revenues can also be inflated by housing and consumption booms, throwing off rules-based calculations of the appropriate level of public spending. A prescient study from 2007 showed that between 50 and 75 per cent of the rise in Spain's tax revenues between 1995 and 2006 might be transitory, and hence disappear once the boom in asset prices came to an end.[23] Finally, there is disagreement over what constitutes an ideal level of debt over the long term; this depends on expected rates of economic growth, on demographics and on the future path of interest rates. With current

23: See Albert Jaeger and Ludger Schuknecht, 'Boom-bust phases in asset prices and fiscal policy behavior', IMF Working Paper, April 2004; and Carlos Martinez, Luis Lasierra and Javier Igal, 'Asset booms and tax receipts: The case of Spain, 1995-2006', European Commission Economic Papers, November 2007.

interest rates at very low levels, the optimal debt level for governments is arguably higher than it was when interest rates were higher.[24]

The second problem with fiscal rules is that they can violate national sovereignty. If rules are perceived by member-states to be outside restrictions on their freedom to set policies, they may not be implemented, as the example of Italy shows. In times of crisis, the European Commission, the ECB and creditor countries might be able to enforce conformity since emergency lending will come with strings attached. But in good times, rules are hard to enforce because the eurozone has less bargaining power vis-à-vis the respective national government. Currently, the fiscal rules are binding for some countries, up to a point. But when the memory of the current crisis starts to fade, the fiscal rules may lose their power to constrain governments.[25]

A sustainable and suitable eurozone architecture needs to combine national sovereignty and political ownership with counter-cyclical policy and debt sustainability. The overall cyclical stance of fiscal policy should therefore be in the hands of a central bank-like authority at the national level, a 'fiscal policy committee' or FPC, whose mandate is to ensure strongly counter-cyclical policies and long-term debt sustainability.[26] Members of the FPCs would be appointed in a similar fashion to central bank governors.

These FPCs would merely make sure that overall policy was sufficiently counter-cyclical, rather than determine the composition of spending or taxes. Such a form of policy delegation would constrain governments in a limited way, but ensure that national institutions – rather than the EU – protected the long-term interests of the public. A further advantage is that the debates around the appropriate stance of fiscal policy would be a discussion between the minister of finance, the parliament and the national FPC, and not between national institutions and outside enforcers.

The FPCs would ensure that national policies more broadly acted counter-cyclically. For example, unemployment insurance can be set so that it acts in a more counter-cyclical way, as in the US, by making payments for longer durations (or in higher amounts) during downturns than in normal times. The same principle could be applied to pensions, which could include an extra payment during recessions, to give pensioners' income a boost when their children are struggling.

24: See Jonathan Ostry, Atish Ghosh and Raphael Espinoza, 'When should public debt be reduced?', IMF Staff Discussion Note, June 2015.

25: For an overview of the track record of the Stability and Growth Pact, see Luc Eyraud and Tao Wu, 'Playing by the rules: reforming fiscal governance in Europe', IMF Working paper, March 2015.

26: Fiscal policy committees are not a new idea, see Charles Wyplosz, 'Fiscal policy: institutions versus rules', National Institute Economic Review, January 2005; and Lars Calmfors and Simon Wren-Lewis, 'What should fiscal councils do?', Economic Policy, October 2011.

The fiscal multiplier

The fiscal multiplier measures the amount of economic expansion that a certain additional amount of public spending or cuts in taxation generates; or the contraction that would follow spending cuts or tax increases. There is a wide range of estimates. The fiscal multiplier is close to zero when additional public spending fully displaces private spending, that is, one additional euro of spending generates no additional economic activity. This might happen during a boom, when the central bank is raising interest rates in an attempt to curb excessive growth in demand. The multiplier is closer to, but below, one in normal times, such that an additional euro generates almost one euro in additional economic activity. In recessions, it has been shown to be around 1.5. And for investment spending during a deep recession, the multiplier is estimated to be around 3 over the medium term.

In a monetary union, there are additional aspects to consider. On the one hand, regional fiscal multipliers have been found to be high because monetary policy is set at the supra-regional level. As a result, local fiscal expansions are not offset by more restrictive monetary policy, and can freely stimulate the local economy. Studying local fiscal stimuli is difficult: often additional spending responds to economic conditions. This makes it hard to know for sure whether it was the fiscal stimulus that led to a rebound in economic activity or simply the economy returning to normal. Researchers have therefore studied cases in which fiscal stimuli were unrelated to the local economy, such as local military spending in the US, or local spending restrictions because of mafia investigations in Italy.

On the other hand, the multiplier might not be large over the medium term even in a monetary union. In cases of past exuberant growth in wages, expansionary fiscal policy could prevent wages and prices from falling, which would prevent firms from regaining competitiveness. Some have argued that high debt levels can also reduce the fiscal multiplier because if the government accumulates more debt through fiscal expansion, it might lead to a sovereign debt crisis further down the line. However, expansionary fiscal policy in a downturn may in fact lower debt levels because it stimulates the economy more than it increases debt, as explained above. In short: counter-cyclical policy in a monetary union is very important, but the context matters, which is why rules-based systems are inadequate.

Sources: Nicoletta Batini, Luc Eyraud, Lorenzo Forni, and Anke Weber, 'Fiscal multipliers: size, determinants, and use in macroeconomic projections', International Monetary Fund, September 2014; International Monetary Fund, 'Is it time for an infrastructure push? The macroeconomic effects of public investment', World Economic Outlook, Chapter 3, October 2014; Emi Nakamura and Jón Steinsson, 'Fiscal stimulus in a monetary union: evidence from US regions', American Economic Review, 2014; Antonio Acconcia, Giancarlo Corsetti, and Saverio Simonelli, 'Mafia and public spending: evidence on the fiscal multiplier from a quasi-experiment', American Economic Review, 2014; Emmanuel Farhi and Iván Werning, 'Fiscal multipliers: liquidity traps and currency unions', Working paper, MIT, October 2013.

Tax exemptions for business investment during downturns also have counter-cyclical effects, as have lower taxes on small incomes during a recession.[27]

FPCs would have a stronger mandate than the fiscal councils that are part of the current eurozone governance framework. These fiscal councils have a monitoring role, supplying national governments with the data needed to conduct fiscal policy in accordance with the fiscal rules. By contrast, FPCs would replace fiscal rules, and would have to approve the budget, ensuring that the fiscal stance was sufficiently counter-cyclical and consistent with long-term debt sustainability.

There are four arguments against policy delegation to FPCs. The first is that experts can fail, too, and could be influenced by vested interests. But no setup will ever be perfect. To ensure that FPCs use the best available data and expertise as well as take public concerns into account, FPCs would need to be transparent, open to criticism and new thinking in the economics profession, staunchly empirical in approach, and accountable both to parliament and the public.

The second criticism is that such delegation undermines democracy, since fiscal policy – the power to tax and spend – is at the heart of every democratic state. However, just like similarly 'undemocratic' institutions such as central banks, independent regulators and competition authorities, FPCs would improve the functioning of democracy: all of these institutions are based on a clear and limited mandate to protect the long-term interests of the public from politicians who might be myopic or influenced by special interests. What is more, FPCs would replace the current rules-based system that also restricts fiscal policy – if it can be enforced. Politically, FPCs are simply a different form of fiscal constraint, and also more accountable to the public.

There are two further, more technical criticisms. In contrast to monetary policy, there is little consensus over what constitutes the ideal fiscal policy or the optimal level of debt. And monetary policy often aims at one target (price stability) with one instrument to achieve it (interest rates), whereas fiscal policy has multiple goals and targets, and needs to find solutions in a continuous balancing act.

These two downsides of FPCs, however, need to be put in context. The FPCs would only ensure that policy is strongly counter-cyclical

27: Further examples are given in International Monetary Fund, 'Can fiscal policy stabilize output', Fiscal Monitor, Chapter 2, April 2015.

and debt sustainable. Those are targets on which there is sufficiently wide agreement among economists – although views differ on the ideal amount of counter-cyclical policy and over the sustainable level of debt. Moreover, the FPCs would be transparent and accountable to evolving views in the economics profession and the public over how to best reach those goals. In fact, the complexity of the task is an argument in favour of FPCs, as they would replace a rules-based system, which, when combined with short-sighted democratic decision-making, is incapable of dealing with the complexity of fiscal policy-making in a monetary union.

The final counter-cyclical policy is macroprudential regulation, that is, the regulation that looks beyond individual banks to the system as a whole, including overall debt levels, systemic risks, and cross-border capital flows. Macroprudential regulation is currently the joint responsibility of national financial regulators and the ECB, as it is considered to be primarily focussed on maintaining financial stability. However, macroprudential regulation serves multiple purposes in the eurozone. Such regulation should protect the financial system from system-wide risks and shocks, but it should also help to even out the business cycle and help stem unsustainable capital flows. Macroprudential regulation should therefore be conducted jointly by the national FPCs, which would be in charge of counter-cyclical policies, and the ECB, which would be the sole financial regulator. Both institutions also need to be given more tools than national financial regulators and the ECB currently have, to fulfil this role.

Would the FPCs take sufficient account of spill-overs between countries? In other words, would, say, Germany's FPC free-ride on other member-states' stimulus programmes and refrain from one of its own? If the ECB ensured an appropriate level of aggregate demand in the eurozone as a whole, FPCs would not be tempted to free-ride. The reason is that a, say, German attempt to do so would prompt others – first and foremost the ECB – to conduct more expansionary policy. Germany would end up with a similar level of demand as a result, just with a different policy mix: less German fiscal stimulus, more monetary stimulus.

In a severe downturn, when the ECB struggles to maintain a sufficient level of demand, there would be scope for free-riding by FPCs of stronger states that are not in need of additional stimulus, when more fiscal expansion would be in the common eurozone interest. Three

aspects would mitigate such free-riding. First, the ECB would have a stronger mandate in the above setup and could hence conduct a more activist policy to push the eurozone out of a severe downturn (spill-overs are largest when the ECB has difficulties stimulating the economy). Second, a limited eurozone budget would mitigate such free-riding as it allows the eurozone to apply stimulus in all countries. Finally, the mandate for the national FPCs should include a provision that in severe downturns, the FPCs of all eurozone countries must mutually agree on their policy stance, to create an appropriate eurozone fiscal response.

The ideal FPC would be a credible national institution, highly regarded by the public and politicians alike, with a macroeconomic mind-set and experience, and not afraid of taking unpopular decisions. Luckily, such institutions already exist in all eurozone countries: national central banks.

As argued above, national central banks should no longer be involved in monetary policy in the eurozone. However, they would be ideally suited for the task of FPCs. In fact, the implicit mandate of national central banks – to ensure macroeconomic stability – would not need to be changed. What has changed for national central banks by being a member of a monetary union is simply the tools for achieving stability: no longer monetary policy but counter-cyclical fiscal policy, and macroprudential regulation. The eurozone should put national central banks in charge of ensuring counter-cyclical fiscal policy, appropriate macroprudential regulation and debt sustainability. The political benefits are obvious: having, say, the Bank of Italy and the Italian government and parliament discuss the appropriate short and long-term stance of Italian fiscal policy is politically far less toxic than if a eurozone enforcer such as the European Commission evaluates Italy's fiscal policy.

The five presidents' report wants to strengthen the macroeconomic imbalance procedure (MIP), to ensure that member-states' policies act in a more counter-cyclical way. The MIP is intended to highlight risks such as excessive credit or wage growth, and to make countries address imbalances such as large current account deficits. There are three problems with this approach. First, the MIP only bites once imbalances have already started to build up, at which point it will be too late. Second, it has little to add when it comes to the optimal policy response during a downturn, as the focus of the MIP is on unsustainable booms, not on periods of excessively weak demand. Third, governments that have allowed these imbalances to build up because it suits them politically, perceive the MIP as EU meddling in internal affairs and avoid implementing its recommendations. Germany is a case in point: the measures it has adopted to tackle its excessive current account surplus are little more than window-dressing.[28]

This paper has now identified the areas in which the policies of eurozone countries need to be fully integrated, and those that should be delegated to independent national bodies. All the remaining economic policies can stay within the remit of national democracies. The most important of these is structural reform.

28: See Simon Tilford, 'German rebalancing: Waiting for Godot?', CER Policy Brief, March 2015.

Chapter 5

Let national democracies decide on structural policies

Structural reforms are changes to the institutions that govern the economy, such as those that cover labour markets, or markets for goods and services. 'Structural reform' is therefore a rather generic term for many different policies. It is commonly used for reforms that bring a country closer to an alleged ideal of a free-market, deregulated and mostly privatised economy. This common use of the term presupposes that economists know which policy mix leads to economic growth (they do not), and that all reforms that bring an economy closer to this supposed liberal ideal are always desirable.

Economists understand that the institutions of an economy have an impact on growth.[29] But there are many different arrangements that have proved successful at different times and different stages of economic development; China is just the most prominent example of an economy that has defied the free-market consensus and succeeded. This is not to say that reforms are undesirable in many countries of the eurozone. But the reform process requires local knowledge of what is required and in what sequence, rather than a one-size-fits-all approach. Politicians need to spend their limited political capital wisely on addressing the most binding constraints that hold back their economies.

In a monetary union, where member-states can no longer rely on national monetary policies, reforms also need to focus on making the economy more balanced and more resilient to economic shocks. The optimal structure of a country in a monetary union may therefore be different from the simple free-market economy benchmark. For example, it might be easier for a country to weather a downturn if firms retained workers but asked them to work fewer hours. A policy that simply facilitated hire-and-fire may be inappropriate in a monetary union.

29: Daron Acemoglu, Simon Johnson and James Robinson, 'Institutions as a fundamental cause of long-run growth', Handbook of Economic Growth, Elsevier, 2005.

Another example is Greece, which in recent years has cut wages considerably. But despite this 'internal devaluation', export performance has been weak, the reasons for which are complex.[30] At the same time, labour reforms and wage cuts have proved costly politically; and falling wages have undermined domestic consumption, depressing the Greek economy. It is therefore questionable whether labour reforms and wage cuts at this juncture were the most effective use of Greek governments' limited political capital.

ECB president Mario Draghi has argued that structural reforms should be coordinated at the eurozone level because all member-states have a stake in any one country's structural reform efforts.[31] Of course, a more resilient, robustly growing Italy would have a positive impact on the economy of, say, France. But his argument is incomplete, and the political costs of having national structural policies mandated from the outside outweigh these potential economic benefits.

To prove his point that structural reforms need to be coordinated at the eurozone level, he would need to show first that there is a conflict between Italy's interests and those of the eurozone. However, on the resilience and growth of the Italian economy, the interests of the average Italian (though not necessarily those of the Italian government) are almost perfectly aligned with those of the rest of the eurozone.

As a next step, Draghi would need to argue that Italian democracy cannot deliver the necessary reforms and that an outside actor either knows better or needs to encourage or enforce measures against vested interests. An outside view might indeed put national obstacles to reforms into perspective, and highlight how other countries have made their economies more productive and resilient. The European Commission should continue to add to the already available views of the OECD, the International Monetary Fund and others, to help democratic deliberation in all countries.

It is also true that it is hard for governments to push through policies against the opposition of particular groups. However, structural policies involve even more complicated trade-offs than the cyclical stance of fiscal policy – and reforms always create winners and losers. In order to remove the principal constraints on growth, policy-makers need to know the economy in depth, and carefully calibrate reforms to its

30: Uwe Böwer, Vasiliki Michou, Christoph Ungerer, 'The puzzle of the missing Greek exports', European Commission Economic Papers, June 2014; and Theodore Pelagidis, 'Why internal devaluation is not leading to export-led growth in Greece', Up Front blog, Brookings Institute, September 12th, 2014.

31: Mario Draghi, 'Structural reforms, inflation and monetary policy', Introductory speech at ECB Forum on Central Banking in Sintra, May 22nd 2015.

specific needs. Democratic deliberation is still the best forum for such complex bargaining and problem-solving.

Where the EU can and should help is in breaking up vested interests through its established means, like fostering competition, protecting consumers through the enforcement of common standards and regulations, and extending the single market, especially into more services sectors. It might also consider common European initiatives that strengthen democracy: for example initiatives to strengthen press freedoms or judicial systems, so that countries are better able to conduct policies in their best interests.[32]

But the imposition of structural reforms from the outside is rarely a success.[33] Eurozone governments have a poor record of implementing the country-specific recommendations made by the Commission under the European semester process. The toxic politics of externally-enforced reform is also the reason why 'reform contracts' – the idea of encouraging countries to implement reforms in exchange for European funds, suggested most prominently by Angela Merkel – has died a silent death.

Rodrik's trilemma, that is, the conflict between national sovereignty, democracy and economic integration, is most binding in the case of structural reforms, compared to policies such as banking regulation or monetary policy: the impact on citizens is immediate and the distributional consequences are potentially large. Hence, the political costs of policy delegation to an independent national body or of an integrated European approach are potentially high. Such measures should only be considered if a country's politics does not allow for solutions – as is possibly the case in Greece, where a persistent form of clientelism undermines policies for the common good.[34]

Advocates of harmonising structural policies have one final argument: different structural policies can undermine solidarity between countries. This could happen, for example, when a country with liberal labour markets and a limited benefits system supports a country with a generous welfare state via a fiscal transfer or risk-sharing mechanism. With the system of eurozone governance outlined in this policy brief, however, the need for mutual support should be limited to severe crises.

32: Robert Keohane, Stephen Macedo, and Andrew Moravcsik, 'Democracy-enhancing multilateralism', International Organization, January 2009.

33: Axel Dreher, 'IMF and economic growth: the effects of programs, loans, and compliance with conditionality', World Development, May 2006; and European Parliamentary Research Service, 'Country-specific recommendations: scorecard for 2013', October 2014.

34: An analysis of 'captured' democracies is Daron Acemoglu, Davide Ticchi, and Andrea Vindigni, 'Emergence and persistence of inefficient states', Journal of the European Economic Association, April 2011. For the special case of Greece, see Christian Odendahl, 'Greece: After a deal, work on a solution', CER insight, June 2015.

Chapter 6

A different eurozone and the current crisis

The eurozone architecture outlined in this paper suggests that it is possible to find the small but crucial middle ground that lies between the economic necessities of a monetary union and the desire of European citizens to be governed by national democracies. But would the system proposed have prevented the eurozone crisis? It is difficult to construct a macroeconomic counter-factual for a 15-year period. Still, it is instructive to highlight how aspects of the above institutional structure would have helped to prevent the build-up of debt, imbalances, financial risk and the divergence of wages and prices; and how it would have helped mitigate the crisis once it hit.

Stronger counter-cyclical policy at the national level could have lessened the divergence of wages and prices that has occurred in the eurozone, in part by restricting booms, and in part by preventing wages and prices from falling too much in struggling countries. The FPCs would also have ensured lower debt levels in some countries, notably Italy, Portugal and Greece, and would have required Spain and Ireland to build up larger fiscal cushions. The role of the ECB as banking supervisor would have contributed a little to stricter macroprudential regulation – but it took the experience of the current crisis for financial regulators worldwide to realise their mistakes.

Once the financial crisis hit, more integrated capital markets and a truly European banking system would have helped spread shocks across countries, rather than reinforce regional downturns. Bank bailouts would not have landed on the balance sheets of national governments but on that of the resolution fund and its backstop. This would have reduced the scale of the credit crunch, which hit southern Europe particularly hard.[35] A more activist ECB would have pursued an

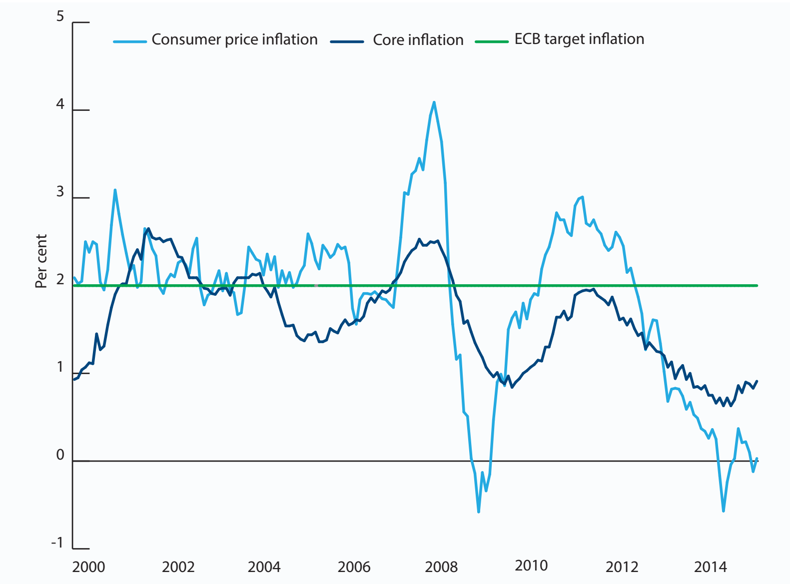
35: The European Commission recently published a research paper showing the likely impact of the (still imperfect) banking union, had it been in place when the crisis hit. The results are striking. Even taking the caveat into account that it is very complex to model such an impact: the GDP losses in the periphery could have been reduced by a third, and those of the eurozone as a whole by 10-40 per cent. See Fritz Breuss, Werner Roeger and Jan in 't Veld, 'The stabilising properties of a European Banking Union in case of financial shocks in the euro area', European Commission Economics Papers, June 2015.

aggressively expansionary monetary policy throughout the crisis, and would not have allowed demand and inflation to weaken as much as they did.

A joint fiscal capacity, and the existence of FPCs would have prevented countries from pursuing pro-cyclical fiscal policies in the downturn, and would have led to a more expansionary stance in Germany in particular. Finally, had the ECB acted as a fully-fledged lender of last resort, it would have prevented self-fulfilling runs on government bonds and threats of euro exits from the start. The financial crisis would have been a lot less severe, the misalignments within the eurozone less pronounced and crisis management would have been a lot better.

Chart 3: Core inflation in Spain and Ireland above target pre-crisis

Source: Eurostat, Haver
Note: Core inflation measures consumer price inflation without energy and unprocessed food, two very volatile (and in the case of energy, globally-determined) prices.



How to overcome the current crisis

The eurozone, however, has chosen different responses to the crisis. As a result, it remains in a chronic crisis of weak economic growth, low inflation, high debt, economic misalignments such as Germany's huge current account surplus and a palpable political backlash against the current policy mix. How would the institutional framework above help overcome the eurozone's current problems?

The high level of public debt in some eurozone countries could be a problem for three reasons. First, it could make self-fulfilling runs on debt more likely. Second, a high level of debt could breed uncertainty, which can undermine the confidence of businesses and investors, thus depressing growth.[36] Third, high levels of debt can limit a country's ability to use fiscal policy to bolster demand.

With the ECB now acting as lender of last resort, the risk of runs on eurozone governments has subsided. Investors are also less concerned about eurozone debt levels than about the lack of demand, for which counter-cyclical policies and aggressive monetary policy are needed, both of which are integral parts of the institutional architecture outlined in this paper. Since markets are calm, governments also do not need to cut spending in a pro-cyclical fashion. After all, as argued above, more restrictive fiscal policy in, say, Spain will not reduce the Spanish debt burden, and markets know this. Contrary to the conventional wisdom in Berlin, Brussels and Frankfurt, eurozone countries do not have to consolidate their public finances in the middle of a crisis or period of weak growth in order to retain the confidence of markets.

The other factors to consider are the misalignments in prices, wages, and current account balances. The approach outlined above would struggle to correct these imbalances quickly, but the correction would be faster than under the current architecture.

The best way to correct the misalignments in the eurozone would be symmetric adjustment. First, countries with excessively low prices and wages need to encourage a slight economic overheating – Germany, for example, needs much stronger growth and inflation than it is currently generating. Second, other countries would need 'to cool down' so that their prices and wages correct, but without causing the economic depressions and unreasonably high levels of unemployment that countries such as Spain or Greece are experiencing. And all this should proceed while making sure that overall level of demand and inflation in the eurozone is kept on target.

In the setup above, the national FPCs of struggling countries would mandate a responsible counter-cyclical policy, such that

36: The best treatment of this argument can be found in Michael Pettis, 'When do we decide that Europe must restructure much of its debt?', blog.mpettis.com, February 25th 2015.

the economies can adjust without going through an economic depression. Germany's FPC might be reluctant to allow domestic overheating. However, it would have to take the eurozone as a whole into account in a severe crisis such as the current one, according to its mandate. Moreover, a more aggressive ECB would also help to stimulate the German economy.

This compares very favourably with the current set of policies: the German economy is expanding at below its potential growth rate; struggling eurozone countries are still conducting pro-cyclical fiscal policies with predictable costs in terms of high unemployment; and while the ECB has recently adopted a more expansionary monetary policy, it remains too little, too late. By addressing one of the eurozone's main problems, a lack of demand, the above setup would help correct misalignments much faster.

Finally, this eurozone architecture would bring the political conflicts about reforms and the right course of fiscal policy back to the national arena, to allow for proper democratic discourse and accountability, rather than fostering anti-European sentiment through outside interference.

Chapter 7
Conclusion

The long-term survival of the eurozone depends on each country being economically better off inside the currency union than outside. Eurozone policy-makers also need to observe the political reality that national democratic accountability is hard to square up with the economic requirements of euro membership. The middle ground between the two is very small.

This paper has outlined a eurozone governance structure that takes both the economic necessities and the political constraints into account: integrate where it is essential to the economic survival of the eurozone; delegate policy to independent national institutions in those areas where democracies can be destabilising; and leave the rest – especially structural reforms – to the national democratic process.

Unfortunately, too many eurozone policy-makers continue to attribute the crisis to excessive public debt and a lack of structural reform. In reality, the crisis had complex macroeconomic causes, in which self-fulfilling runs on government bonds, banking systems tied to national governments, and a lack of counter-cyclical policies – both at the national and the eurozone level – all interacted to create a perfect storm.

Analysed through the lens of Rodrik's trilemma, the eurozone has moved towards the worst combination possible: economic policy integration where it is not necessary or misguidedly focused on fiscal consolidation and structural reforms; combined with a political setup that is perceived to be based neither on national sovereignty nor on democracy – at least in economically weak countries.

The five presidents' report rightly calls for the completion of the banking and capital markets union. It also aims to strengthen the democratic accountability of eurozone policies, which is useful and overdue, although a true European polity will take a long time to develop. In addition, the fiscal rules are currently being reinterpreted to take better account of the economic situation of countries. Meanwhile, the eurozone's lack of demand, reflected in very low inflation rates, is now central to the discussion, and the five presidents emphasise the importance of the eurozone's aggregate fiscal position. The structural reform process in the EU will, the five presidents hope, be streamlined to appear less like external micro-managing and more like a eurozone-wide effort.

However, there are as many reasons to criticise the five presidents' report – and the state of the eurozone's current governance arrangements – as there are to praise it. Structural reforms and fiscal consolidation still play too prominent a role, and the focus, at all levels, has not shifted nearly enough in favour of strongly counter-cyclical policies. Moreover, the suggested policy integration at the eurozone level is not limited to the most essential questions (banking, financial markets, the lender-of-last-resort role of the ECB, and demand management at the eurozone level) but includes structural reforms, even though the case for centralising structural policies is weak.

The current political realities are not conducive to a re-think of the eurozone's institutional architecture. Too much political capital has been invested in the common narrative of the eurozone's problems: that the sorry state of the eurozone is mostly the result of fiscal imprudence and shirking of structural reforms. But if the eurozone is to thrive both economically and politically, it needs to focus laser-like on what needs to be reformed, and then to carry out those reforms boldly.

★

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We don't need no federation
What a devolved eurozone should look like

Christian Odendahl

At the heart of the eurozone's troubles lies a fundamental contradiction between the euro's integrationist economic pressures and the politics of democratic nation-states. To resolve this, the eurozone should only integrate – but do so radically – where it is economically essential: in banking and financial markets, in building a lender of last resort, and in ensuring a sufficient level of eurozone demand. The eurozone should leave as much as possible to its member-states, including structural reforms – where the case for integration is weak, and the political costs are high. Instead of eurozone fiscal rules and common enforcement, the responsibility for ensuring sound fiscal policies and sustainable debt should be delegated to independent national institutions. Luckily, national central banks, the former guardians of economic stability, are currently underemployed and would be ideally suited for this task. If the eurozone is to thrive both economically and politically, it should focus on those areas that need a common European response, and then carry out reforms boldly.

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