How (not) to reform the Euro Area's economic governance

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European monetary union presents a paradox. On the one hand, despite three years of continuous battering and pounding, the euro still exists. On the other hand, the crisis has revealed serious flaws in the governance of the Euro Area and it has become clear that the old system of managing the euro macro-economy is not sustainable. This paper attempts to explain this apparent contradiction and how to resolve it.

The bright side of European monetary union

The robustness of a payment union

European monetary union has been remarkably robust. It has survived the Global Financial crisis after the Lehman bankruptcy and is now in its fourth year of the Greek crisis, which has contaminated the whole Euro Area. Yet, the euro has not disappeared or broken up. This robustness is a result of the institutional features of a monetary union and the pivotal role of the European Central Bank (ECB). Its President Mario Draghi has said repeatedly that the ECB "will do whatever it takes to preserve the euro", and with the new Outright Monetary Transaction (OMT) Program deeds have followed his words (Collignon, 2012b). Compare this to the previous European Monetary System (EMS), which fixed exchange rates, but collapsed after less than 4 month of speculative attacks in1992. Before discussing the governance of the Euro Area, it is useful to clarify the distinction between a fixed exchange rate regime and a currency union, because it shows why "Economic and Monetary Union (EMU) and the introduction of the euro as the currency of the European Union were milestones of European integration and are crucial for the economic, social and environmental well-being of the citizens" (European Commission, 2012).

In a fixed rate system, the stability of exchange rates, i.e. the price for foreign currency, depends ultimately on foreign reserves held by the central bank, because monetary authorities can use these reserves to intervene in the market and supply or buy foreign currency in order to balance market disequilibria. When the bank runs out of reserves, the exchange rate will depreciate. With free capital flows, exchange rate stability is always vulnerable to sudden stops of inflows or excessive outflows of capital. Foreign exchange reserves are, therefore, the external budget constraint of an economy. Note that foreign exchange reserves are an asset on the central bank's balance sheet.

A monetary union functions differently. It is not a fixed exchange rate system. It is a payment union. This means that within the currency area payments are not made with foreign currency, but with domestic money, even if they transfer funds between different member states. Base money, i.e. legal tender, is obtained by banks when the central bank gives them credit against collateral or buys financial assets outright. The central bank provides liquidity; there is no need to earn "foreign" currency.

Banks hold central bank money as deposits on their account with the central bank, or they exchange deposits against bank notes which they supply to their clients. Thus, the central bank is the bank of

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banks and as such it is the lender of last resort to the banking system as a whole. It is this function of the European Central Bank having the capacity to provide all the required liquidity to the banking system, which makes the currency area robust against shocks. Yet, money needs to be scarce in order to fulfil its function of being a store of value. How much money commercial banks can borrow in aggregate depends on monetary policy and this constitutes the domestic budget constraint of an economy.[2] Note, however, that base money is a liability of the central bank. Hence, interpreting a monetary union as a fixed exchange rate area constitutes a category mistake, which confuses assets and liabilities and the internal and external budget constraints. The proper way to analyse a currency area is to treat it as an economic unit: the currency area determines what an economic country is.

Welfare gains and losses from monetary union

The robustness of a currency area is one of the necessary conditions for sustaining the internal market. In fact, monetary union was created as the institutional complement to the Single European Act, which set up the single market. The internal market was intended to overcome the stagnation and loss of international competitiveness that Europe experienced in the 1970 during a period of monetary instability with high inflation and exchange rate volatility following the demise of the Bretton Woods system.

The European Monetary System (EMS) was an attempt to create a “zone of monetary stability” in 1979, essentially by pegging exchange rates to the deutschmark and pursuing deflationary policies. The Single European Act in 1987, which set up the internal market, was the supply-side response to economic stagnation. By removing non-tariff barriers to trade, a more efficient allocation of resources was expected to generate welfare gains. But this required exchange rate stability. In an efficient market the competition between firms allocates resources and capital to the production of output which maximizes consumer utility. Given that capital, together with labour, is one of the most important factors of production, a single market requires the free flow of capital, but also fixed exchange rates. Otherwise the movements of exchange markets would continuously shift the relative prices of goods and the return of capital without reflecting the quality of products and their utility for consumers. Thus, exchange rate volatility distorts the efficient allocation of funds.

In a highly influential report, Padoa Schioppa (1987) had shown that the four policy objectives of achieving free movements of goods and services, free flow of capital, fixed exchange rates, and conducting national monetary policies were mutually inconsistent. With free flows of capital, monetary authorities had to set interest rates so that they would attract capital and stabilize foreign exchange reserves, especially when current account deficits required balancing capital inflows. Furthermore, the need to stabilize exchange rates through DM-pegging required frequent and potentially large variations in interest rates, which also distorted the level playing field for the costs of capital in the European internal market. Thus, a fixed exchange rate regime was not consistent with a single internal market. The only way to overcome this obstacle was to give up national monetary policies and unify them under the authority of the European Central Bank. European monetary was then seen as a Pareto-improvement of European welfare.

However, centralising monetary policy came at a cost. Governments would give up national sovereignty to conduct their economic policies according to their own preferences and they lost the

2 In normal conditions, most central banks steer the money supply through the setting of interest rates, but with interest rates close to 0 and high liquidity preference, unconventional monetary policy measures may focus on monetary aggregates. See Collignon, 2012a.

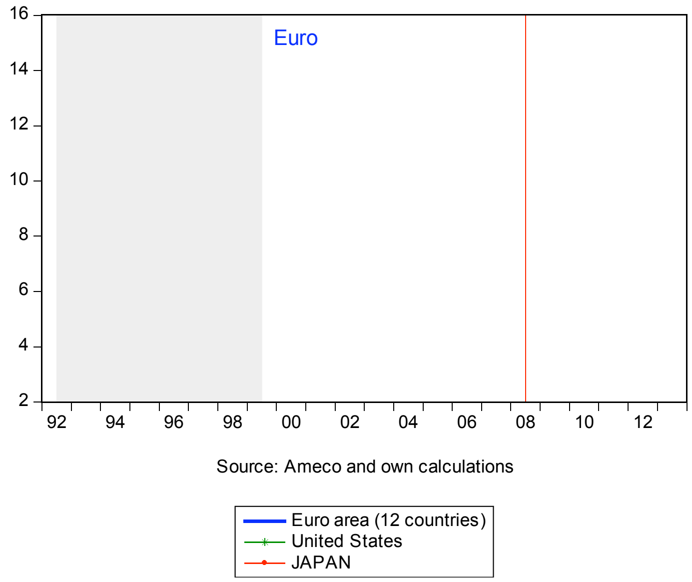
tool of adjusting the exchange rate. Optimum Currency Area theorists argued that with real rigidities in the labour markets, the exchange rate was a suitable tool to correct distortions (Mundell, 1961). Yet, the experience of the 1970s had already proven that there were rapidly diminishing returns from using this "instrument" (Collignon, 2002). As for monetary sovereignty, it had already been lost for all member states but Germany. As the largest country with regular current account surpluses, Germany enjoyed lower interest rates than the rest of the system and the deutschmark became the benchmark for monetary policy in the other member states. Thus, when national monetary policies sought to stabilize exchange rates, they had to follow the policies of the Bundesbank, which alone was able to conduct autonomous national policies. However, then as now, Germany's "national interests" did not always coincide with the common interests of European citizens (including, of course, German citizens). Creating monetary union was therefore a political decision, even if the purpose of improving welfare was economic.[3]

This suboptimal arrangement of fixed exchange rates was put aside, when the European Central Bank took over, assumed responsibility for the monetary policy of the Euro Area as a whole and provided all the necessary liquidity for the smooth functioning of the banking system. Not surprisingly, welfare started to improve. Figure 1 shows the misery index (the sum of inflation and unemployment) for the Euro Area, the USA and Japan. It is a rough way to measure welfare losses. While Europe has structurally higher misery than the other countries, the gap between the Euro Area and the US started to shrink after the Maastricht Treaty was adopted. It remained fairly stable, even after the dot.com boom crashed, although in America welfare losses increased during the Bush era, first gradually and then dramatically with the crash of the global crisis. In Japan, the misery index has remained remarkably stable and low, despite two "lost decades" during which the debt ratio rose to 225 percent of GDP. However, Europe's favourable environment changed after the Global Financial Crisis 2007/8. The misery index jumped up in Europe and in America, but while in the US welfare losses have started to come down after the Obama administration massively stimulated the economy, in Europe the debt crisis and austerity have created prolonged misery.

Figure 1.

3 Contrary to other Optimum Currency Area theorists, Mundell (1998) was very clear that money is a political and not an economic institution.

Misery index

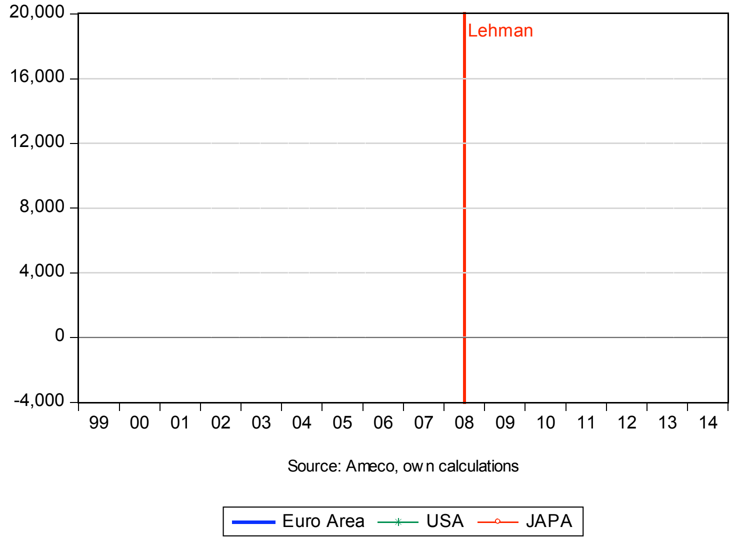


Source: Ameco and own calculations

The improvement in the European misery index during the first decade of the euro is due to falling unemployment and to price stability, with inflation meeting the ECB objective of 2 percent. Most importantly, the Euro Area has created nearly 18 million in the first ten years of monetary union, while in the decade before only 4.4 million workers found new jobs. It is true that since the financial crisis in 2008, more than 4 million people have lost their work, but on balance, Europe is still 13-14 million jobs ahead. See Figure 2. Interestingly, more jobs were created in the Euro Area than in the United States and job losses after the Lehman crisis were less. However, the European debt crisis which started with Greece in 2010 has prolonged employment losses in Europe, while the US economy is now picking up again. Japan is losing jobs at a steady rate, which in part reflects the shrinking labour force since 1997.

Figure 2.

Cumulative job creation since 1999
Euro Areas, USA, Japan



Source: Ameco, own calculations

Thus to conclude, when it worked well, monetary union has brought many improvements to the European economy by fostering monetary stability, creating new jobs and raising general welfare. But it no longer does. Maybe crises are unavoidable in capitalism, just as droughts were in traditional rural subsistence economies. What makes a difference, however, is how a crisis is managed. This is where the Euro Area has failed because of its incomplete governance which risks wiping out the benefits it had achieved.

The dark side of European monetary union

Despite initial successes, the European monetary union is now fighting for survival. In order to dispel doubts, ECB-President Mario Draghi was forced to declare repeatedly: "The Euro is irreversible". There are two reasons for this sudden fragility. One is the nature of the Euro crisis, which is trapped in a vicious negative feedback loop, the other is the failure of Europe's economic governance, which prevents getting out of the loop.

The nature of the Euro crisis and policy responses

There are three ways to look at the European debt crisis. For the *fiscal fundamentalists*, the debt crisis is caused by lack of budget discipline. The Stability and Growth Pact (SGP) was insufficiently observed by the Member States and lacked robust mechanisms to ensure sustainable public finances (European Commission, 2012). For *macroeconomists*, the vulnerabilities stemmed from a lack of tools to address systematically macroeconomic imbalances between member states and the excessive accumulation of private debt. For the *monetarists*, the European debt crisis has blown up into a fulfledged liquidity and banking crisis. Each of these explanations has an element of truth: public debt is clearly a problem in Greece and Italy, private debt in Ireland and Spain. Lack of liquidity has caused a credit crunch and reinforced recessionary dynamics everywhere.

However, taken at their own, each of these explanations misses out on the spillover effects on the other dimensions. External shocks like the Lehman bankruptcy, or the revelation of fiscal crimes and other misdemeanours under the Karamanlis government in Greece, have caused the collapse of asset prices collapse, especially in southern member states where national statistics showed current account deficits. This had the consequence that banks' balance sheets were damaged. Their capital reserves shrank, often below safety reserve requirements, and banks responded by deleveraging, collectively causing a credit crunch and economic crisis. The profitability of investment in the affected regions was reduced, the recession deepened, and further reinforced the credit crunch. While the lifting of national budget constraints after the introduction of the single currency had allowed the deficit countries to allocate resources more efficiently and import high quality goods, thereby generating widening current account deficits, this source of aggregate demand was now withering away. The imbalances seemed to get corrected, as the Commission (2012a) gleefully noted, but this was hardly due to structural improvements but simply the consequence of austerity. The Euro Area as a whole stagnated, with some regions falling into deep recessions and only Germany and the Netherlands benefitting from massive liquidity inflows.

The crisis lead to partial and insufficient policy responses. Fiscal fundamentalists recommend debt breaks and austerity, thereby making the banking crisis worse. Macroeconomists call for the reduction of "external" imbalances (although they mean *internal* balances within the Euro Area)[4], thereby

4 See for example European Commission (2012a).

imposing additional austerity on regions which suffer already from rotating slumps.[5] Finally, monetarists believe that the ECB alone could solve the crisis by providing the “big bazooka” of becoming the lender of last resort not only to banks, but also to governments (De Grauwe, 2011). This solution has the handicap that it could generate moral hazard and invites freeriding without solving the structural problems behind the crisis.

These fragments of crisis analysis reflect Europe’s unsolved governance problems. Because there is no unified economic government, partial solutions are proposed without taking into account the externalities they cause, and they are therefore incapable of producing a general equilibrium that would optimise citizens’ welfare. Nevertheless, the European Commission (2012) has now presented a *Blueprint for a deep and genuine EMU*, which aims at integrating and deepening the different reform packages, which have been introduced since the beginning of the crisis. The institutional innovations adopted over the last few years are impressive, although highly technical and rather byzantine. Yet, while the blueprint contains many interesting ideas, it ignores the elephant in the room: where is the European power to conduct and enforce coherent policies?

Institutional reforms

The so-called *Six-Pack* contains European laws directive covering not only fiscal, but also macroeconomic surveillance under the new Macroeconomic Imbalance Procedure (European Commission, 2012b). In the *fiscal field*, the reforms strengthen the Stability and Growth Pact (SGP) by defining quantitatively what a "significant deviation" from the medium term orientation is that requires correction. They also operationalize the debt criterion, so that an Excessive Deficit Procedure may now be launched if a member state’s debt ratio is above 60% of GDP and not diminishing. Reverse qualified majority is needed to over-rule sanctions.[6] The new Treaty on Stability, Coordination and Governance (TSCG), also referred to as "Fiscal Compact", adds little to the budget rules of the SGP, although it stipulates that the SGP-rules shall be implemented in *national* law through provisions of "binding force and permanent character, preferably constitutional". Nevertheless, the European Court of Justice may impose financial sanction if a country fails to comply. This creates a new ambivalence about the role of national versus European sovereignty. The odds are that national elections will take priority over an international court.

In addition, the *Two-Pack* covers two regulations with the aim of improving coordination and surveillance of deficits in Euro Area member states. The implementation of common budgetary rules at the national level shall be monitored by independent institutions. However, while monitoring is good, defining a common policy would be better. Member states will share a common budgetary *timeline*, but not yet a *budget line*: they must submit their draft budgetary plans to the Commission and the Eurogroup before national parliaments will vote on them. The European Parliament, as the representative of the European general will, has no role in this. Hence, either this is a further step in

5 The concept of “rotating slumps” was first formulated by Olivier Blanchard and has been formalised by Landmann, 2009.

6 *Reverse qualified majority voting* implies that a recommendation or a proposal of the Commission is considered adopted in the Council unless a qualified majority of Member States votes against it. The European Parliament is not involved.

hollowing out democracy, or it is useless. With all likelihood, it is the later: if the Commission finds that national budget plans do not comply with the SGP, it can require governments to revise their plans. Otherwise "it may address an opinion to the Member States concerned, which would also be discussed by the Eurogroup" (European Commission, 2012b). What a threat! Clearly, this procedure is a paper tiger: European authorities have no power other than persuasion; national parliaments remain fully sovereign in voting their budget laws. But what will happen when the people in their infinite wisdom elect a national parliament that disagrees with the Commission or the Council? This is the unsolved question of Europe's governance.

Finally, the *Macroeconomic Imbalance Procedure (MIP)* is a surveillance mechanism that aims at preventing and correcting macroeconomic imbalances within the EU (European Commission, 2012c). It relies on an alert system that uses a scoreboard of indicators and in-depth country studies. Alert thresholds have been set to detect potential imbalances, although they are not applied mechanically. A new Excessive Imbalance Procedure (EIP) can impose financial sanctions for member states, which do not follow up on recommendations. It will require member states to submit corrective action plans, and the enforcement with sanctions is largely copied on procedures in the SGP. One may wonder how efficient this would have been in avoiding the crisis in Ireland or Spain.

The final and still incomplete chapter of institutional reform is the *European banking union*. A genuine monetary union is more than a policy rule for issuing money. As pointed out earlier, money is supplied by granting credit and the central bank needs commercial banks to monitor the creditworthiness of debtors (Riese, 2001; Wyplosz, 2012). If the crisis has been caused by the excessive accumulation of private and public debt, banks must not have done their job correctly. Hence, they need to be supervised more efficiently. Furthermore, as the lender of last resort to the banking system, the ECB needs to provide liquidity to all solvent banks in order to prevent bank runs. Yet, it is ill equipped to distinguish between solvent and insolvent banks, because it has limited information about banks and no authority to intervene. Traditionally, responsibility for baning supervision has remained in the hands of national authorities who could also restructure and recapitalise banks, but often procrastinated for perfectly rational reasons (Myers, 1977; Stein, 2010).

The key to avoiding future crises is therefore more efficient banking surveillance by the ECB, complemented by transferring powers and regulations for bank resolutions and deposit insurance to the European level. This is what the Van Rompuy Report (2012) and the Commission have suggested, but as usual, the Council has kept the power of European authorities to a minimum. The agreement on a Banking Union made in December 2012, praised by van Rompuy as a historic achievement, has set the barriers so high that effectively only 160 out of 6000 banks in the Euro Area will now pass under the supervision of the ECB. However, these new supervisory responsibilities have also a drawback: while the new responsibility strengthens the power of the ECB, the only functioning federal authority in the EU, there is a risk of overload. Ultimately, the ECB will only be able to function effectively and maintain its independence, if it can work with a political authority that is capable of acting without delay in a crisis and can rely on the democratic acceptance of its decisions by European citizens. Despite brave talk in the van Rompuy Report (2012) about democratic legitimacy and accountability of decision making, the Euro Area is far from such an institutional balance. This is the Achilles Heel of the European monetary Union.

The dilemma of efficiency and legitimacy

The gap in the performance between the United States and the Euro Area described above has not only institutional reasons. There is also a difference in economic policies pursued in the two economies. In the US, macroeconomic policy is centralised at the federal level. A political debate about the right set of policies, for example whether to implement Keynesian demand policies or neoclassical austerity, is decisively settled by elections. The federal government then applies the chosen policies for better or worse. In Europe, this is not the case. Monetary policy is conducted at the European level, but the rest – especially fiscal policy - remains national. Critique of the ECB is usually motivated by the idea that monetary policy should accommodate partial national interests ("one size does not fit all"), but this defeats the idea of achieving efficiency gains from European integration. The contradiction between centralised monetary policies and decentralised macroeconomic management is unsustainable in the long run. The national bias in economic policies is inefficient for two reasons: first, it prevents the conduct of efficient macroeconomic *policies,* in the sense of deliberate, strategic and decisive actions that respond to the crisis; there is no institution with the power to implement it. Second, the lack of power to implement proper policies is sustained by legitimacy concerns. It results from the decision to keep democracy to the local level and not give citizens a right to authorize economic policies collectively at the European level. This creates a dilemma, because democratic legitimacy can directly be claimed by national governments, but not by European institutions, and therefore the latter are lacking the authority for exercising the power of implementing policies which would overwrite local preferences.

I will first discuss the problem of efficiency and then deal with legitimacy issues in the next section.

Efficiency

The ECB can only control interest rates and money supply, but the other dimensions of economic policy remain undetermined. Member state governments implement policies that reflect local preferences for austerity, growth or tax evasion, but the aggregate outcome is random. Europe's economic governance does set limits on some parameters, say on budget deficits or now also on macroeconomic imbalances between member states, and it does seek cooperation between governments, such as by setting up the "European Semester"[7], but the efficiency and effectiveness of this governance is highly questionable.

Because public borrowing affects effective demand, monetary and fiscal policies interact. In order to preserve macroeconomic stability, a single currency union requires the definition of an aggregate fiscal policy stance. In federal unions, this stance is provided by the federal budget. Yet, the budget of the European Union is not even 1 percent of GDP, while government spending by Member States varies between one third and one half of GDP. This makes it impossible for the Union budget to act as a shock absorber, while national budget policies can cause major disturbances for the Euro Area as a whole. The Stability and Growth Pact does not solve this problem, even in it "reformed" and "strict" new version, because it only sets maximal limits for debt and deficits without defining a coherent macroeconomic fiscal stance that could manage short term demand and stabilise the economy.

In its present form, fiscal policy is inefficient, because it cannot be used as a tool to stabilise macroeconomic developments in the Euro Area as a whole as long as nation states are autonomous. Autonomous decisions made by sovereign nation states generate externalities for other Member States. As long as countries have separate currencies, these effects are absorbed by exchange rate variations. In monetary union, by contrast, uncoordinated fiscal policies in any region will affect the flow of

7 The European semester is a six-month period every year during which the member states' budgetary and structural policies are reviewed to detect any inconsistencies and emerging imbalances. The aim is to reinforce coordination while major budgetary decisions are still under preparation. (http://www.consilium.europa.eu/homepage/showfocus.aspx?lang=en&focusID=66743)

funds within the Euro Area as a whole (Collignon, 2012c) and this has inevitably unintended consequences for all other regions. In other words, national autonomous fiscal decisions generate externalities which affect all citizens in the Euro Area, but the Euro Area has no mechanism to internalize these externalities other than the Stability and Growth Pact. For this reason, the definition of the fiscal stance should be undertaken at the European level and not by member states. But this poses the even bigger question of how such aggregate fiscal stance can be legitimated.

Legitimacy

This brings us to the core problem of the economic governance in the Euro Area: how to combine efficiency and legitimacy. Efficiency means making coherent policy choices and being able to carry them through. We may call the output of these policies *European public goods*. Legitimacy means policies must be authorized by all citizens who are affected by them. The link between the two is the scope of externalities: people share public goods by the fact that their individual utilities and welfare are affected by them. The principle that those who are affected by a policy must have the right to control it is the core of the democratic republican paradigm.[8]

Legitimate European policy-making requires more than a *derivative democracy*, where governments lend their democratic credentials to European institutions. People must have the possibility to choose and that can only be achieved through universal suffrage. In other words, European citizens must be allowed to realize their *sovereignty as owners of common European public goods* by authorising a representative government to exercise power on their behalf. By contrast, in today's intergovernmental system, there is no government acting as the trustee of all the people who are affected by the euro and the related macroeconomic policies. Member state governments are not only exercising *power*, they have also usurpated the *authority* (sovereignty), which legitimises power. In this system, citizens are not the owners of public goods, but the subjects of member states. The consequence is that citizens cannot be the ultimate authority that generates the "general will" of what policies should be implemented; instead, governments block each other in the exercise of power.

Attempts to break the power gridlock end up with the *pensée unique*, which may be one of the reasons why, contrary to the United States, Europe is locked into the crisis with few sign of coming out of it. While in a federal system, power is contested, the contest of power in the intergovernmental system suppresses political opposition, because a policy compromise between governments must not be put into question for otherwise no action is possible at all. In political debates, policy makers frequently claim that "there is no alternative" and that they "know what to do, and only need to do it".[9] In other words, there is only one "right" policy. If implemented correctly, the policy output would generate support for Europe. In a less apodictic form the claim is reduced to the idea that support for the European project could be re-gained by "concrete projects", through which citizens experience the gains from integration. However, this is wrong on two accounts.

First of all, it may be asked why these policy makers are not implementing the policies of which they seem so convinced. What is missing from orthodox statements is the understanding that the lack of

8 For an in-depth discussion of the concept of a *European Republic* see Collignon, 2003; 2013.

9 The classical example is *Tony Blair's* Speech to the European Parliament (23 June 2005). See: http://newsvote.bbc.co.uk/mpapps/pagetools/print/news.bbc.co.uk/2/hi/uk_news/politics/4122288.stm

democratic input blocks output legitimacy and leads to the quasi permanent gridlock in European politics. Proper implementation may therefore never happen, even assuming that we know what is right. Secondly, there are different options for policies and the reduction of alternatives to "one right model" evacuates democratic choice. The Troika, for example, may act as a centralised European policy making unit, but it has not been legitimised by European citizens, who chose the policies they want to see applied. This form of governing the euro has the dangerous and unintended consequence that it marginalises all alternative policy preferences. There is no room for "loyal opposition" when there is no alternative to what authorities decide. This governance fuels therefore the rejection of European policies *and* institutions. During the recent crisis, this problem nearly caused the break-up of the Euro Area, when the first round of Greek elections did not yield a majority acceptable to the European consensus, or when Berlusconi stated a rampaging campaign in Italy against Merkel and Germany.

There is presently much talk about a 'federalist leap' necessary for the survival of the euro. However, it is not clear what federalism means. The name covers two diametrically opposed policy visions. The Swiss-German tradition sees the benefits of federalism in decentralisation and subsidiarity of political decision making (Burgess, 2000); it thereby creates more externalities and enlarges the issues of policy inefficiency. Alternatively, the US American tradition of the Federalist Papers has insisted on the need for a central government in order to overcome collective action problems (Dougherty, 2003). But without restoring the sovereignty of the people against the "sovereign state", the lack of democratic legitimacy in Europe will not permit efficient policies in time.

There is, however, a way out: designing the European Union as a Republic, where the owners of public goods appoint a government by democratic choice that then has the power to act in their common interest (Collignon, 2003). This European Republic is a logical necessity, not an utopia. It simply draws the conclusions from Europe's history.

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