Political Lessons from the Economics of the Euro Crisis

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There is something impressive about the Euro: after nearly five years of pounding and hammering, it still exists. Compare this to the previous European Monetary System, which collapsed within three weeks after being attacked by speculators in the financial markets. This institutional stability stands in sharp contrast to the social and political turmoil it has brought about in many member states. Thus, one should not condemn the Euro too quickly even if it is in crisis. Is the source of Europe's economic suffering due to its currency or is it a consequence of mistaken policies? Blaming high unemployment, slow growth, fiscal austerity and high taxes on the Euro is understandable, given that Europeans are told that *only* austerity and deep structural reforms cutting into the welfare system can save the common currency (Schäuble 2011). There comes a point when, despite the greatest love for European unification, people will no longer put up with daily hardships as their sacrifice for a distant goal. But what if the problems were not due to the institutional arrangement of common money, but to mistaken policies? In that case, we should conclude that the Euro crisis is political, not economical.[1]

That the half-build house of monetary union without political union may not be sustainable has been understood from the beginning. During the Maastricht negotiations, the German Chancellor Kohl sought to complement monetary by political integration, but the project was intellectually not yet as advanced as monetary union (Featherstone and Dyson 1999). Nevertheless, most protagonists of European Monetary Union (EMU) have always thought that a single currency will ultimately force member states to move to a political union (Collignon and Schwarzer 2003). If this has not happened (yet), it is not the fault of the Euro, but of European politics. In this chapter, I will suggest that the real crisis of monetary union results from the fact that the European economy's deep tissue integration has no counterpart at the political level.

For economic liberals the lack of political integration may not appear as a disadvantage because they resent interference with the 'invisible hand' of the market. They believe that the creation of the European single market is all it takes to maximise welfare. But if private transactions generate externalities and national policies affect citizens in other member states, a more 'visible hand' in the form of rules, regulations and discretionary government action is needed. For nationalists, only the nation state has the legitimacy to impose rules and policies on citizens and they simply ignore the external effects of domestic policies on neighbours – and even indirectly on their own citizens. For nationalists on the left, preserving the welfare state in times of economic crisis is incompatible with more European integration. They are therefore willing to accept the disintegration of the Euro and ultimately the European Union. That, of course, would undermine the very foundations on which European welfare is built. None of these solutions will ultimately help European citizens to lead a better life.

[1] See also Bergsten and Kirkegaard 2012, who come to a similar conclusion

Fact is that European integration, and especially the Euro, has generated many economic interdependencies and externalities - some positive, some negative. Unfortunately, these externalities, many of which are related to European public goods such as macroeconomic stability, cannot be managed in a coherent and efficient manner without a political union that defines common welfare and gives sense and direction to economic policies in the Euro Area.[2] I will argue that the problems revealed by the Euro crisis are primarily based on the disjunction between an integrated economy and a splintered polity and show why the Euro is a source of potential strength, which cannot unfold properly, because the political institutions for governing the Euro Area are inadequate for the conduct of welfare improvements.

1. The amazing robustness of the Euro system

It was part of the pre-Maastricht discourse to think of EMU as a fixed exchange rate system, where member states have permanently pegged their exchange rates to each other.[3] It follows that one could exit the Euro and re-peg the exchange rate *in extremis*. Yet, this description of monetary union is not correct. There are no national currencies in the Euro Area. The Euro has replaced all previously existing currencies. The Euro Area functions exactly like any other currency area, where credit contracts can be enforced and extinguished by paying the legally defined and generally accepted currency. On 1 January 1999, the earlier monetary laws were abrogated and the Euro became legal tender (TEU, art. 3.4) in the participating member states. The European Central Bank (ECB) was set up as the directive organ and head office for the conduct of monetary policy. The existing National Central Banks (NCB) were merged with the ECB to form the Eurosystem. The abrogation of national monetary laws has, therefore, lifted the distinction of monetary jurisdictions and turned the Euro Area into an 'economic country'.

The difference between a fixed exchange rate system and a currency union is important, and it hinges on the difference between domestic and foreign money. Domestic money is the liability of the central bank. It is created when central banks grant credit to commercial banks. Broad money includes the liabilities of commercial banks, which hold deposits on behalf of their clients in the 'real' economy. Thus, whether narrow or broad, money is always the liability of the banking system. Payments are made by transferring these liabilities between economic actors. Currency, that is coins or the pieces of paper we carry in our pockets, are nothing else than a certified document of such liabilities, which banks can draw against their reserves at the central bank and then put into circulation with their clients.

By contrast, foreign money is the liability of a foreign central bank. It cannot be 'created' by domestic banks. In order to make a foreign payment, one has to earn foreign currency or get a loan from a non-resident. When a European firm sells products or European securities in the United States of America (USA), it will be paid dollars, which are foreign assets for the exporter, but domestic liabilities (money) for the American banking system. If the European exporter decides to exchange her foreign currency against Euros, she must find a partner who is willing to swap his domestic asset (Euros) against her foreign asset (dollars). Usually banks do this exchange. For example, a bank can buy the exporter's dollars and sell them to the European Central Bank. The foreign currency will then end up as an asset

[2] For a discussion of European public goods and their efficient administration, see Collignon 2002b; 2011.
[3] See Delors Report 1989.

(foreign exchange reserves) in the balance sheet of the ECB. Hence, the difference between domestic and foreign currency is clear: *domestic money is a liability, and foreign money is an asset in the balance sheet of banks*.

The different sources of domestic and foreign money have far-reaching consequences: a currency area can run out of foreign currency but not of domestic money. If economic agents wish to exchange more domestic currency against *foreign* currency than the central bank can cover with its reserves, the price for domestic money will depreciate until the excess demand for foreign currency is eliminated. By contrast, if a bank needs more *domestic* liquidity because its clients have transferred their money balances to another bank or into neighboring regions, it can borrow from other banks *or from the central bank*. Since Bagehot (1873), it has been universally understood that central bank lending to solvent banks must be without limit in the very short run, but can be controlled over the medium and long run by setting interest rates in pursuit of price stability. The open discount window ensures that the central bank is the lender of last resort to the banking system[4] and thereby preserves the stability of the financial system. This makes the Euro Area so robust. Despite the mitigating role of the IMF, there is no equivalent lender of last resort for foreign currencies at the international level.

As a consequence of the difference between domestic and foreign currencies the adjustment mechanism does not function in a currency area as it does in international economics. If a country runs current account deficits, they must be financed by capital inflows from abroad. If these inflows suddenly stop, as it occurred during the Asian crisis in 1997, deep currency depreciations will follow, usually coupled with steep recessions and reductions of financial wealth. Within a currency area, a region that imports more than it exports will experience an outflow of money, but it is not dependent on capital inflows because local banks can borrow from the central bank. This is why currency areas are sustainable even if regional deficits persist for a long time. If a currency area would not work in this way, no nation state would ever have survived. Italy's north and south would have separated, the United Kingdom would have split into England and Scotland, and Bavaria and Catalonia would have introduced their own currencies.

In the Euro Area, southern member states ran large current account deficits, which were largely financed by banks borrowing savings from local residents or neighbouring countries or new funds from the ECB. On the background of the Global Financial Crisis, the Euro crisis started as a public debt crisis in Greece. As banks and lenders started to doubt the solvability of debtors, they stopped providing credit. Soon the crisis turned into a private debt and banking crisis in Ireland, Spain and Portugal. Risk averse households and non-financial corporations started to save massively and hold their savings in liquid form or they accelerated repaying outstanding liabilities. Thus, the credit boom was followed by a credit crunch. As aggregate spending shrank, economies fell into recession. Although the ECB cut interest

[4] See: Santos and Peristiani, 2011. The ECB's role as a lender of last resort to banks is beyond dispute; there is less agreement, however, whether it should also be a lender of last resort to governments. This has been the contention between the ECB and the Bundesbank with respect to Outright Monetary Transactions (OMT) program of buying government bonds under certain conditions.

rates, the lower cost of credit did not compensate lenders' risk averseness and investment fell.[5] The resulting crisis was deep in terms of output and employment losses, but financial wealth in the Euro Area, and relative prices and costs between different member states remained stable, at least initially.[6] This stability was achieved by the Eurosystem lending to crisis economies and recycling the excess liquidity from the north. These payment flows are reflected in the so-called TARGET2 balances, which record claims an liabilities among national central banks in the Euro system. Far from being a threat, these monetary transfers between central banks are precisely what ensures the sustainability of the system.[7]

One may argue that flexible exchange rates could make the adjustment in the crisis easier. In the context of an integrate economy like in Europe, that is no longer true. Currency depreciations are changing relative prices between domestic and foreign economies and small independent countries may be able to free-ride on undervalued real exchange rates without major side-effects for global trade. But for big economies this is not the case. Flexible exchange rates, which are largely driven by asset markets, will generate competitive distortions and disturbing uncertainties in goods and capital markets. The purpose of European monetary union was to eliminate such barriers to trade and investment. It has worked. Large European corporations have restructured their supply side to reap the full benefits of comparative advantages. They have outsourced and delocalised parts of their supply chain to regions with lower cost and more adequate skill profiles and this has allowed them to resist or minimise the loss of world market share in view of the dynamic performance of emerging economies. The consequence has been a fragmentation of national production, but a deepening of European integration and also the growth in the internationalisation of the European economy (Esposito and Guerrieri 2013). Germany has been the leader in this process, but the logic applies to all member states. However, this process would not have been possible without a single currency.

In fact, while economic theories suggest that changing the *level* of exchange rates may be a useful tool for adjusting relative prices, they often ignore the detrimental effects of exchange rate *volatility*. Volatility increases uncertainty for future returns on capital; the longer the time horizon, the larger the uncertainty. This has two consequences. On the one hand, there is value in waiting until the situation gets clearer, so that holding back investment will lower growth and employment. On the other hand,

[5] The argument can be formalised as follows. Let us assume that the required return on investment r is the cost of borrowing i plus the risk premium ρ. The return is the operating surplus, i.e. the share of income going to capital. Income is a function of capital. We then have in equilibrium

$$r I = (i + \rho) I = mkI$$

where m is the profit margin and k the productivity of capital and I investment. This can be expressed as

$$\rho = mk - i$$

It is immediately clear that an increase in risk ρ would require a lowering of interest rates or an increase in profit margins and/or capital productivity. If interest rates are at their lower zero bound, monetary policy is powerless. If there are limits to how much wages can be lowered to increase profit margins, capital productivity has to be increased. But if capital productivity follows the law of diminishing returns, the implication is reducing the capital stock, which means negative investment.

[6] In Greece and Cyprus, financial wealth was destroyed by haircuts for government debt, but this loss was significantly less than the depreciation of all domestic assets in the Asian case.

[7] The discussion about TARGET2 balances was launched by Sinn and Wollmershaeuser 2011. For a critique see Collignon 2012.

given the uncertainty of future returns, investors will ask for a risk premium in order to be compensated for the possibility of not being able to realise the expected rate of return. But at these higher *required* rates, there will be less profitable investment opportunities available. So, once again, investment, growth and employment will be reduced.

In order to counter these negative effects of exchange rate volatility, governments are often pegging their currencies to one of their main trade partners. This reduces uncertainty at the micro level, and generates currency blocs at the macro level.[8] However, currency blocs do not last forever because the net benefits are unfairly distributed between the center and the periphery. The key currency benefits from stability with neighbouring trade partners, but its exchange rate becomes more volatile with respect to other global currencies. Peripheral currencies must tolerate these movements passively, but when the volatility between key currencies becomes too large, the blocs break up. Furthermore, the country with the key currency in the bloc usually sets the interest rate in accordance to its own stability requirements, while the peripheral countries need to keep their interest rates higher in order to prevent sudden outflows of capital. As a consequence, peripheral economies suffer from a structural comparative disadvantage due to the high cost of capital, which cannot be compensated by occasional currency adjustments.[9]

This monetary instability is a permanent threat to the sustainability of the single market. Economists like Tommaso Padoa Schioppa (1987) have therefore concluded soon after the European Single Act had set up the internal market that the free flow of goods and capital and the need for stable exchange rates were incompatible with autonomous monetary policies. Creating the Euro was the answer to this problem. Eliminating exchange rate uncertainty has boosted trade (Rose 1999). Nitsch and Pisu (2008) found that the *propensity* by firms to export into the Euro Area and the *number of products* that exporters ship to EMU member countries have increased after the introduction of the Euro. These effects are stronger for small and less productive firms. In other words, they have supported not only Germany, but also the peripheral economies where the share of small enterprises is large. Hence, there is empirical evidence that the creation of the Euro has achieved precisely what it was meant to achieve: improved competitiveness, more trade, and higher welfare. So if the Euro Area is now in crisis, what has gone wrong?

2. Explaining the Euro crisis

Several models dominate the analysis of the Euro crisis: At first, it was believed to be a *public debt crisis*. However, financial markets quickly also worried about private debt which was accumulated during the

[8] For a formal model describing the emergence and demise of currency blocs, see Collignon 2002a.

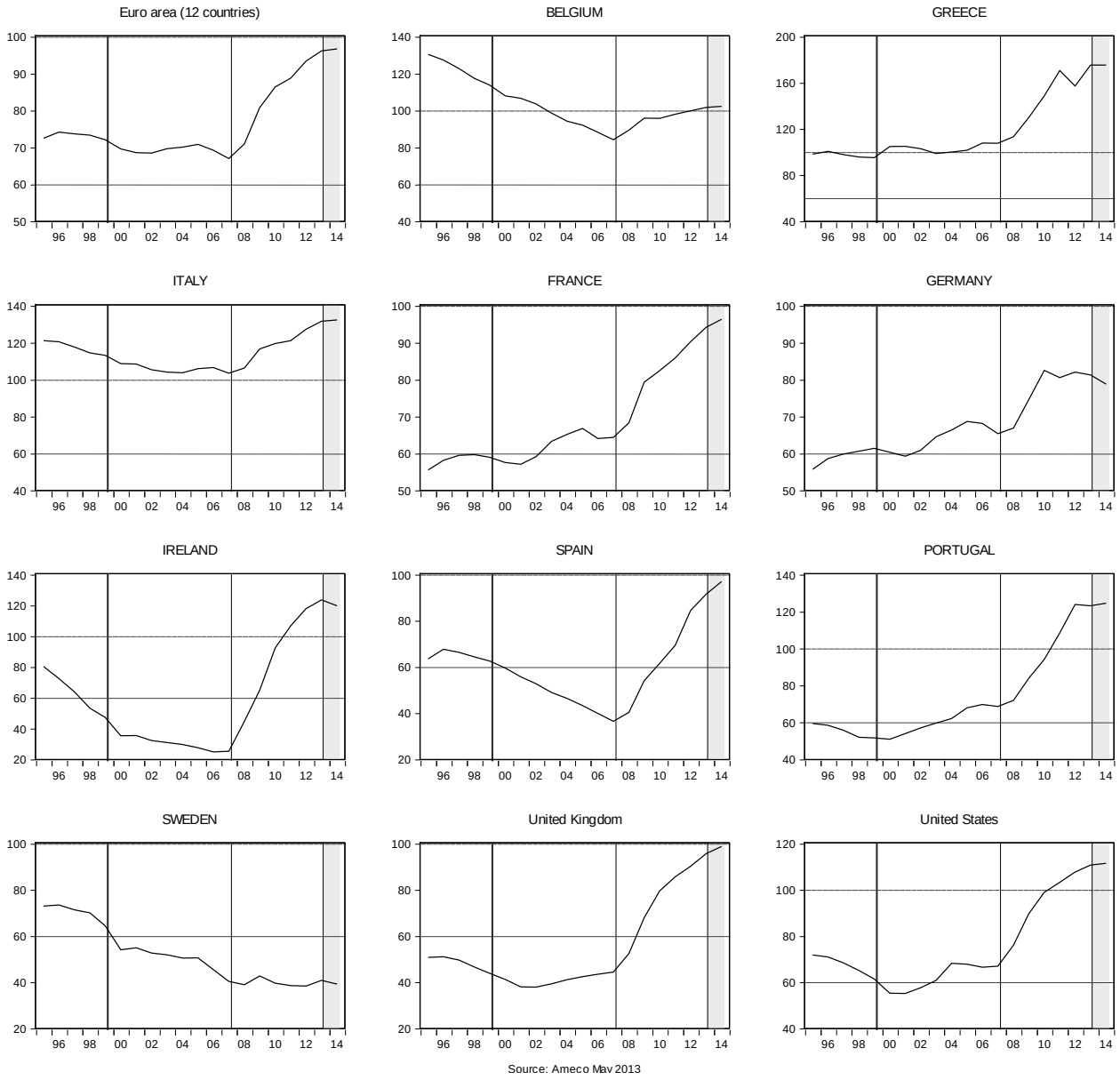
[9] The German Chancellor Merkel has recently regretted that the euro keeps interest rates in Germany lower than what would be required by the German economy (http://www.faz.net/aktuell/wirtschaft/europas-schuldenkrise/vor-ezb-zinsentscheid-merkel-fuer-deutschland-muessten-zinsen-hoeher-sein-12161702.html). This view involves a double mistake. On the one hand it ignores that in a currency area excess liquidity is recycled through the central bank. On the other hand, it ignores the detrimental effects of not having the euro: German interest rates would go up, the German currency would appreciate and monetary stability in the single market would collapse. This could hardly be in the German interest.

previous boom. The Euro crisis became a banking crisis. When it appeared that many banks had become vulnerable because they had lent excessively to member states with large *current account* deficits, the analytic focus shifted to macroeconomic imbalances. As the new policy consensus sought to balance current accounts of member states. While this meant reducing expenditure in the midst of a crisis, international economics also taught that macroeconomic adjustment may require a change in real exchange rates and this raised the issue of *competitiveness* cost and labour market developments. Each of these approaches contains parts of truth, but partial policy responses have not been able to pull the Euro out of the crisis. For this reason, we will have to place these explanations in the context of the *financial and banking crisis*.

Fiscal policy and debt

The Greek debt crisis was triggered when the newly elected Prime Minister Papandreou revealed that previous Greek governments had knowingly and secretly violated the rules of the Stability and Growth Pact (SGP). Trust in the institutions of Europe's fiscal policy vanished, markets were in turmoil and policy makers sought to tighten fiscal policy and balance public deficits. The idea that fiscal profligacy has led governments to accumulate unsustainable mountains of debt is particularly popular in Germany. But in this crude form it is too simplistic. Figure 1 shows that prior to the Global Financial Crisis, public debt-to-GDP ratios were falling in most Euro Area states, with the exception of Germany, France and Portugal. Yet, Germany is unscathed by the crisis, France has struggled and Portugal collapsed. Ireland and Spain were well within the limits of public debt set by the SGP before the crisis and nevertheless they got into deep trouble. Fact is that in all countries inside and outside the Euro, including the USA, debt ratios did shoot up after the Lehman bankruptcy in 2008. Thus, it is not so much excessive borrowing by irresponsible governments, but rather the economic impact of the Global Financial Crisis on output and tax revenue that has pushed up the debt burden.

Figure 1. Debt to GDP Ratios



Source: Ameco May 2013

Even if there was no fiscal profligacy, one may argue that public debt did not fall enough, especially in highly indebted countries like Greece and Italy, and that consequently highly indebted countries did not have the necessary margins to stimulate the economy when they were hit by the crisis. Comparing Italy and Belgium highlights this: Belgium started monetary union in 1999 with a debt-GDP ratio of 130 per cent, Italy with 120 per cent. By 2007, the Belgian debt level was down to 88, the Italian to 106. Thus, Belgium consolidated 42 per centage points during the happy boom years, Italy only 14 points. During this time, Italy had consistently higher positive output gaps (1.7 per cent of GDP on average) than Belgium (0.9), and that exerted higher inflationary pressures on the Italian economy and has hampered competitiveness. The cyclically adjusted deficit, which according to Europe's fiscal rules should have been in balance, was on average -0.75 per cent in Belgium, but -3.84 per cent in Italy. After 2008, Belgium could therefore increase its cyclically adjusted deficit to -2.8 percentage points of Gross Domestic Product (GDP) on average, but in order to prevent the risk premium from rising to

unsustainable levels Italy had to cut its deficit back by 1.6 percentage points to -2.2 per cent. Thus, fiscal prudence before 2008 allowed Belgium to better absorb the crisis shock: after 2008 the average output gap, i.e. the difference between actual and potential output was -0.8 per cent in Belgium, but -2.2 per cent in Italy.[10] Hence, by avoiding fiscal consolidation during the boom years, Italy had no margins for fiscal stimulus in the crisis. Playing by Europe's rules before the crisis would have made it easier to avoid austerity after the crisis.

From this point of view, the tightening of fiscal rules in accordance with the new Fiscal Compact (*Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*) may appear as a step into the right direction. Member states are committing themselves to introduce the stringent rules of the SGP into their own constitutional framework. The treaty defines a budget as non being excessive if the general budget deficit is less than -3.0% of the GDP, and the cyclically adjusted deficit is less than -1.0% of GDP, provided the debt-to-GDP ratio is significantly below 60%; otherwise the cyclically adjusted deficit shall be below -0.5% of GDP. The treaty also defines the rate at which debt levels above the limit of 60% of GDP shall decrease.[11] These rules constrain the margins of national fiscal policy and could thereby reduce negative externalities for the Euro Area.

The problem with this arrangement is its rigidity. While the rules are reasonable during the boom, they may not give enough breathing space in a severe crisis. For example Belgium would have had to consolidate its cyclically adjusted deficit even more during the boom years, but it could not have run an average structural deficit of -2.9% to stimulate the economy after 2008. This rigidity will cause pro-cyclical consolidation and increase the amplitudes of output gaps, which will translate into high levels of structural unemployment. This is precisely what happened in 2010, when European governments responded to the Greek crisis by an early exit from the stimulating fiscal policies adapted in 2009. The result was a double dip recession with ever worse social consequences. European fiscal policies were the opposite of what the Obama administration did in the United States when it responded flexibly and efficiently to the economic situation. Thus, the political lesson European authorities have drawn from the European debt crisis was the imposition of austerity and tighter fiscal rules, while the proper way out of the crisis would have required discretionary measures as in the USA.

A better reform of Europe's fiscal rules would have been a policy framework that allows stabilising the economy by responding with anti-cyclical measures to large booms and busts. Fiscal rules should be conditioned on output gaps. When output gaps are positive, budgets should be in surplus and debt should be repaid. When output gaps are negative, fiscal consolidation should not be imposed and some leeway for discretionary stimulus should exist. It is easy to understand why the reform of fiscal policy rules has gone wrong. The Euro Area has no institution with the power to make discretionary decisions. For that a genuine 'economic government' would be required. Because they are afraid to lose power, the 17 dwarfs of European governments are tying down the Gulliver of the European economy until it can no longer move. Unemployment is the price to be paid for this mistake.

[10] These figures are based on the Commission's AMECO database and take averages for the period 1999-2007 and 2008-2014.
[11] See http://en.wikipedia.org/wiki/European_Fiscal_Compact

After Greece, the crisis spread. Ireland became the paradigmatic case for private debt problems, which spilled over into the banking system after the property bubble had burst. When interest rates had come down in the early years of EMU, credit was cheap and banks were lending generously, especially to the real estate sector. House prices in many southern countries had risen, and this had broadened the scope for collateral lending. Following the Lehman shock, the credit boom collapsed, collateral became insufficient and banks' balance sheets came under severe pressure. In Ireland, Spain, Greece, Portugal, Belgium, Netherlands, Germany and later also in Cyprus, governments had to bail out banks in order to avoid a systemic melt down of the banking system which would have had severe spillover effects for the rest of the Euro Area. When the national funds needed for the stabilisation of the system exceeded national capacities, a European bail-out fund - first the temporary European Financial Stabilisation Facility (EFSF) and later the more permanent European Stabilisation Mechanism (ESM) - had to step in. This established a close nexus of public and private debt crises, which now had external effects on member states in the north, because taxpayers in the non-crisis countries had to bail out debtors in the south. Severe political tensions developed, for suddenly Europe was no longer played as a benign positive sum game, but driven by nasty distributional conflicts. In nation states such conflicts get solved by the democratic process, but in Europe policy makers sought new methods to deal with this issue by setting up a *Troika* that imposed austerity without a democratic mandate and by creating the new *Macroeconomic Imbalance Procedure*.

Macroeconomic imbalances

Analysts were quick to recognise that member states with private debt problems also had run large current account deficits during the boom. As any economic textbook teaches, current account deficits increase the external debt of a country. If these countries had run large current account deficits, they must also have accumulated foreign debt, and the solution to high debt was to rebalance current accounts between member states in the Euro Area. Through the so-called Six-pack legislation, the European Commission set up a new procedure to avoid macroeconomic imbalances. However, the prominent focus of the procedure on current account balances within the Euro Area was another policy mistake, for it has reinforced austerity unnecessarily.

Current account balances are identical with the sum of public sector savings and the private sector savings-investment balance. From national income accounts we can formulate this identity like this:

$$CA = (T - G) + (S - I)$$

where a current account surplus (CA) is determined by the government's budget balance between tax revenue (T) and spending (G) and by the difference between private savings (S) and investment (I). It is clear that if the current account deficit is to be reduced, the public sector must cut the deficit and the private sector must increase savings or reduce investment. Hence, policies focusing on reducing current account deficits in the Euro Area will reinforce austerity and restrain economic growth. But this is a mistake, for exiting the crisis requires higher growth and increased investment, especially when concerns about debt sustainability prevent expansive fiscal policies.

The policy error of aiming at balanced current accounts between member states of the currency union originates in the mistaken belief that regions in the same currency area are economically to be treated as if they were foreign countries. We have seen above that this is wrong, because the economic distinction is the currency. The current account balance matters between different currency areas, because it indicates the growth of foreign debt in foreign currency. To service this debt, an economy must earn foreign currency. Therefore it is at some point necessary to generate positive current account balances. In fact, the simple rule of foreign debt sustainability says that the discounted value of all future expected current account position should be equal to the amount of outstanding debt. However, as we have seen above, within the same currency area the story is different. Current account deficits between member states of the currency area are not building up foreign debt, because local governments or companies borrow domestic currency, which is supplied by the central bank and not by trade surpluses. Of course, credit must be paid back. But because the funds to do so are denominated in Euros, it does not matter whether the debtor's income is earned by net exports or by the expansion of sales in the non-tradable sector. Therefore, the need to balance current accounts has disappeared; instead, there is the need to generate cash flow sufficient to service the debt.

There is another argument why balancing current accounts between member states is a fallacy. For such a balance implies that local borrowing by the corporate and public sector is financed by local savings, so that member states become financially autonomous. But this is contrary to the idea and principles of a fully integrated market. In a single market, savings should be allocated where they yield the highest return. There is no reason, why say investors in Ireland should only borrow savings from Irish households. In fact, Irish growth would be severely constrained by such a limitation. The proper functioning of a currency union would imply that capital moves into regions with above average returns to capital and as a consequence current accounts may deteriorate. But in this case, it is the region's comparative advantage, which creates the deficit and not a lack of competitiveness.

The basic lesson from our analysis of how a monetary union works is that, rather than balancing current accounts, macroeconomic policies in the Euro Area must focus on balanced growth. The necessary and sufficient condition to ensure debt sustainability in a currency area is that local debtors' cash flow exceeds or at least equals debt service obligations. On the macro level this implies either that output grows at the same rate as interest rates in firms' liabilities, or that profit margins increase if output growth slows down. Because profit margins are the difference between prices and unit labour costs, the issue of wage bargaining and competitiveness has rightly entered policy debates.

Unit labour costs and competitiveness

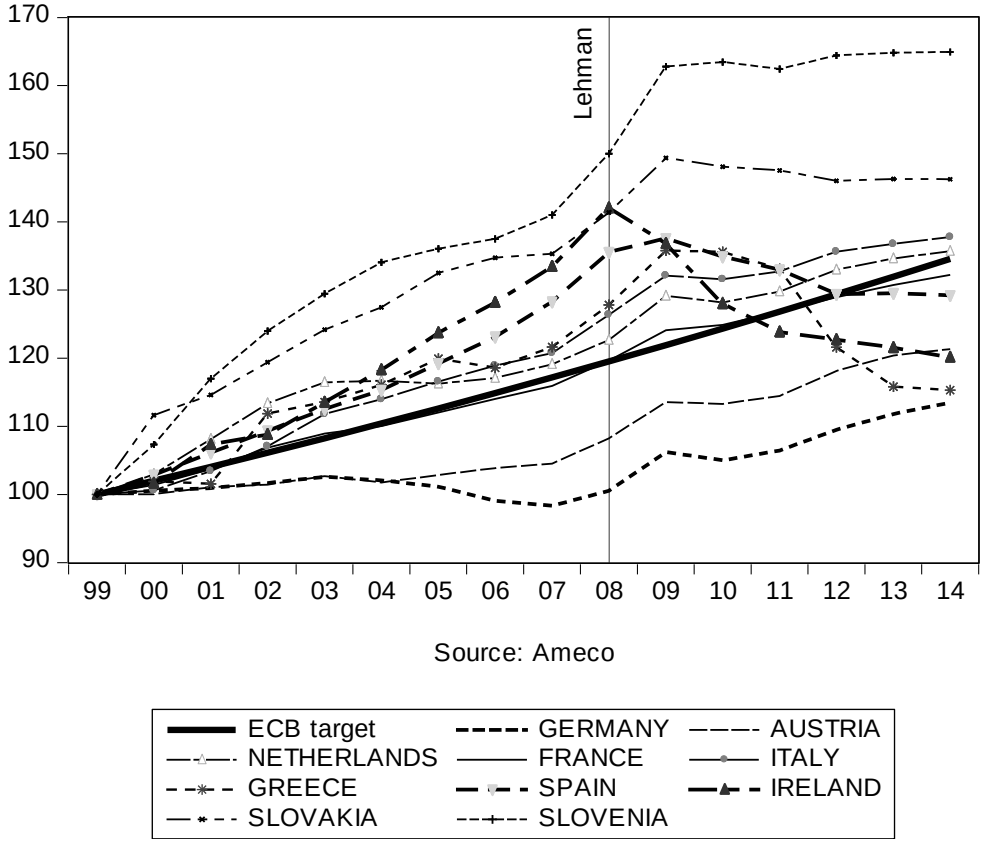
Competitiveness has had its role in the Euro crisis. If regional costs and prices diverge significantly, investment will leave uncompetitive regions and local growth will slow down. The question is then how the cost adjustment is to be achieved. Europe's prevailing policy consensus has used austerity as the main adjustment tool and the European Commission (2012) has rejoiced that it is working. Others have

argued that the social costs are too high, and they have called for 'an orderly exit from the Euro' (Flassbeck and Lapavitsas 2013). This would be the end of monetary union.

The exit argument hinges essentially on the assumption that wage and price dynamics in the Euro Area have generated huge competitiveness gaps. Usually, unit labour cost indices are shown as evidence. These indices have their base year in 2000 and then trace the evolution of nominal wage compensation relative to productivity in different member states. Figure 2 is an example. It shows that in most southern member states unit labour costs have increased faster than the ECB-inflation target (thick straight line), while in the north (Germany and Austria), wage restraint has prevented unit labour costs from rising. Hence, labour cost gaps have emerged. For example between 1999 and 2007, unit labour cost increases in Greece have exceeded German developments by 27 per cent and in Italy by 22 per cent. Some conservative economists have suggested wage cuts of similar proportions to restore competitiveness (Sinn 2013). On the left, the reasoning is similar, although the policy solution of wage cuts is rejected in favour of dismantling the Euro (Flassbeck and Lapavitsas 2013).

However, the argument is flawed. First of all, we observe that in Slovenia and Slovakia the competitiveness gap would have been even higher than for Greece, but so far these countries have not been pulled into the Euro crisis. On the other hand, the Netherlands, which have a huge trade surplus with the Euro Area, also seem to have accumulated competitive disadvantages. Secondly, adjustment is already taking place in many crisis countries. For example, unit labour costs in Greece are now close to German levels and in Ireland they are comparable with Austria. But this does not seem to have stopped the crisis in these member states. Thirdly and most importantly, there is no good reason to assume that the year 2000 represents an equilibrium position so that the diverging indices show unsustainable divergences in labour cost. A country may have accelerated wage inflation because its unit labour cost level was well below average or because capital productivity has gone up. Cost indices like Figure 2 are not suitable to assess *levels* of competitiveness. We therefore need to find an equilibrium benchmark against which cost developments can be judged.

Figure 2. Unit Labour Cost Indices

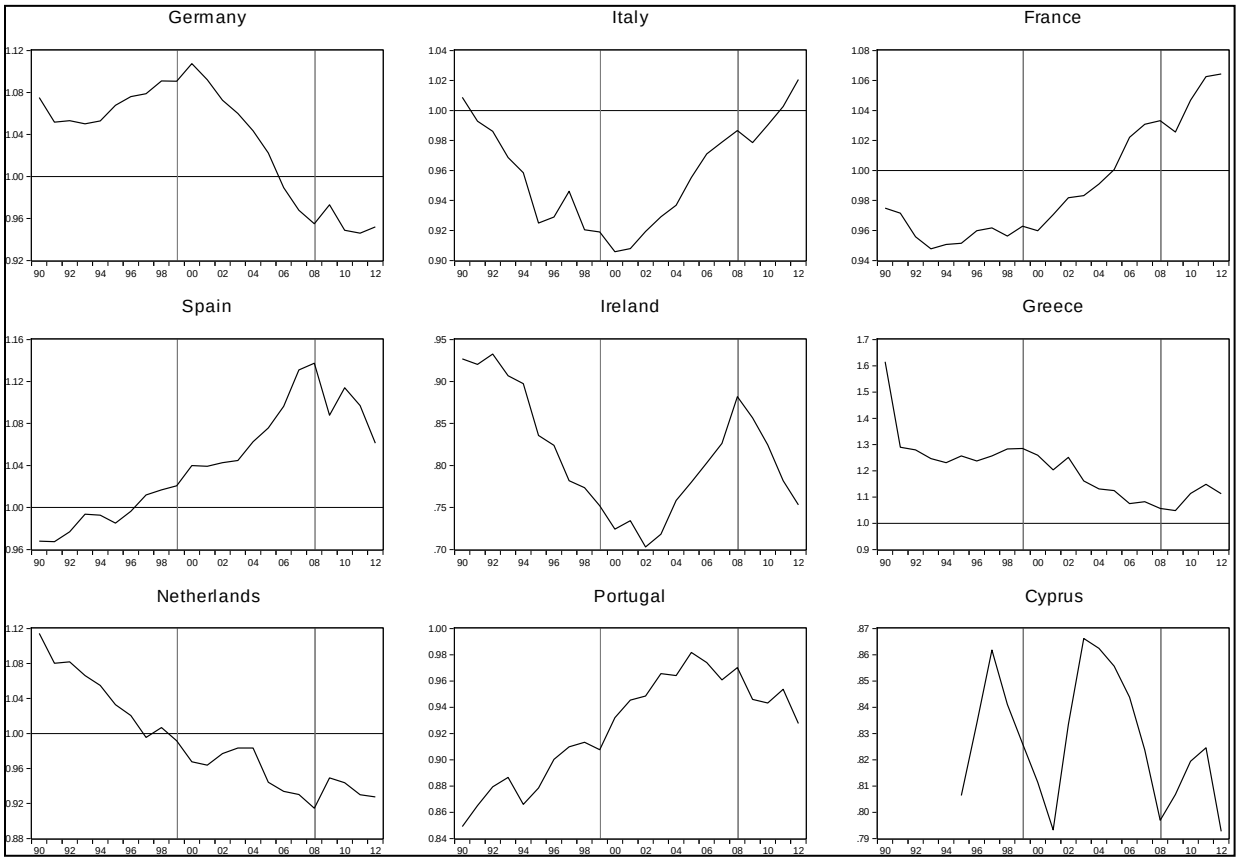


Source: Ameco

De Grauwe (2011) has tried to solve the base year problem by taking a long historic average as base, but this is just another *ad hoc* index without theoretical foundation. There is, however, a simple solution: in an efficient market economy, returns of capital are supposed to converge in equilibrium. Taking the Euro Area as the benchmark, we can calculate the national level of unit labour costs, which would generate the return to the national capital stock equal to the Euro Area's average. By calculating the ratio of actual unit labour costs relative to the equilibrium level, we obtain an index that correctly reflects the excess of a member state's unit labour costs above or below equilibrium.[12] It has the advantage not only of being grounded in sound economic principles, but also of taking into account the difference between labour costs and prices, that is profit margins and the impact of capital productivity. Figure 3 shows the index for some Euro members. As expected, we find that in most southern member states competitiveness has deteriorated before the crisis, but only in Spain and France did this lead to overvaluations, while Germany and the Netherlands have moved from over- to undervaluations.

[12] An index value of 1 indicates that the national ULC level generates the same return as the Euro average. For a detailed description, see Collignon 2012 and Collignon and Esposito 2013

Figure 3. Competitiveness index for selected Euro area countries



Source: Ameco and own calculations

Table 1 shows that, with the possible exception of Greece, labour cost overvaluations are relative moderate in the Euro Area. They are far from the drama painted by the index in Figure 2. Italy, for example, has lost competitiveness since the Euro started, but today its labour cost levels are close to the equilibrium position, at which the Italian capital stock generates the same return as Euro Area average. Slovakia, which has a huge 'competitiveness gap' according to Figure 2, is actually deeply undervalued. The Netherlands, on the other hand, seemed overvalued in Figure 2, but in reality the country has improved competitiveness. Austria is still overvalued, even if it has improved its situation, and the same was true for Greece before 2007, although at higher levels. Surely, these proportions of overvaluation do not warrant an exit from the Euro Area and in some crisis countries unit labour costs are actually undervalued.

Table 1. Over- and Undervaluation of Unit Labour Costs

	1999	*change*	2007	*Change*	2011
Slovakia	-33.0	*-8.5*	-41.5	*0.2*	-41.2
Luxemburg	-32.9	*-6.3*	-39.3	*3.8*	-35.5
Malta	-28.6	*1.1*	-27.4	*-1.0*	-28.5

Estonia	-19.6	*-2.9*	-22.5	*0.1*	-22.4
Ireland	-24.8	*7.4*	-17.4	*-4.4*	-21.8
Cyprus	-17.4	*-0.2*	-17.6	*0.1*	-17.5
Finland	-13.3	*-2.5*	-15.7	*3.2*	-12.5
Netherlands	-0.8	*-6.1*	-7.0	*0.0*	-7.0
Germany	9.1	*-12.3*	-3.2	*-2.2*	-5.4
Slovenia	-12.3	*-0.4*	-12.8	*7.6*	-5.2
Portugal	-9.2	*5.3*	-3.9	*-0.7*	-4.6
Belgium	0.4	*-4.2*	-3.9	*-0.2*	-4.1
Euro Area	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
Italy	-8.1	*6.0*	-2.1	*2.4*	0.3
Austria	12.7	*-6.5*	6.2	*-1.9*	4.3
France	-3.7	*6.8*	3.1	*3.2*	6.3
Spain	2.1	*11.0*	13.1	*-3.4*	9.7
Greece	28.5	*-20.3*	8.2	*6.6*	14.8

Source: Ameco and own calculations

The debate on unit labour costs has nevertheless some merit. For it highlights that incoherent wage policies can cause competitive disadvantages which would slow down regional growth and, as we have seen, this can turn into a systemic risk in a monetary union. No doubt, with sufficient labour and capital mobility, the market's 'invisible hand' would eliminate such distortions. There is, in fact, evidence that labour mobility has increased since the crisis (Bräuninger 2011; ECB 2012). But losing skilled workers is hardly a welfare enhancing tool for the periphery. In the long run, nominal wage flexibility may therefore be preferable to migration as an adjustment instrument and in this context it is worth reflecting on the methods and systems of wage bargaining. One reason why unit labour costs in the south may have increased faster than in the north is the fact that in the south, the protected public sector takes leadership in wage bargaining, while in the north, especially in Germany, wage bargaining is let by industrial sectors, which are exposed to international competition (Visser 2013). If the other sectors follow the leader, unit labour costs in the different regions diverge.

A second reason for labour cost divergence is the suspension of the Phillips curve, according to which wage increases slow down when unemployment is high and increase when it is low. There is evidence that in the first decade of the Euro, this relationship did not work in the south (Collignon 2013a; CER 2013). One explanation is that following the convergence in interest rates, the European credit boom has generated 'irrational exuberance' not only for investors but also for wage bargainers. Since the crisis, however, the Phillips curve has returned. High unemployment is now lowering wage claims again. Nevertheless, a better explicit coordination of wage bargaining in the Euro Area could render the wage adjustment less costly in terms of employment and would therefore contribute to more balanced growth. Hence, as a first step, a reform of the European wage bargaining system should establish the principle that the tradable sector, which is exposed to international competition, shall be the leader for wage bargaining in all member states. Additional steps could be undertaken by establishing closer concertation and coordination between trade unions in the Euro Area.

Financial crisis and banks

All the theories we have discussed so far are based on non-financial explanations of the Euro crisis. However, not taking properly account of monetary and financial developments can lead to policy errors. Money integrates the economy, but it also creates conflicts. Because money acts as the general budget constraint on the market system, it often requires making hard choices. Money is also an engine of growth, for money is credit and without growth interest claims cannot be paid (Riese 2004; Collignon 2013b). Banks, which create money as the intermediaries between savers, investors and central banks, play therefore a central role in the adjustment process of the Euro crisis. If banks do no longer lend, or if firms no longer wish to borrow, a recession is inevitable.

There are two reasons why growth in peripheral regions of a currency union may underperform. Both are related to uncertainty. The standard argument is that banks may not lend to regional firms because they fear their bankruptcy; similarly, firms may not expect to make sufficient profit to be able to reimburse their loans. Essentially this is an argument of insufficient profitability and cash flow *in a given risk environment*. As was pointed out above,[13] increasing profit margins is not necessarily the answer to this problem when economic and political uncertainties generated high risk premia. Neither cutting labour costs, nor lowering interest rates by the central bank will then pull the local economy out of its local slump or even depression.

There is also a second explanation for reduced borrowing and investment even if the cash flow of firms is high. Koo (2002) has called such situation a *balance sheet recession*, which often follows a financial crash. A financial crisis usually originates in a shock to the prices of a specific asset classes, such as real estate. If these assets are financed by nominally fixed liabilities, the net worth of the asset owner will deteriorate. This generates pressure to deleverage the balance sheet, i.e. to reduce liabilities. The higher the leverage, the more vulnerable is a firm to shocks. To reduce their risk exposure, firms will use their cash flow to pay back debt rather than borrow and invest in new assets. If uncertainty is high, increasing profits and cash flows will simply accelerate the deleveraging process. Yet, without borrowing, there will be no investment, growth will collapse and insolvency risks will increase further. With the growing probability of corporate and bank defaults, uncertainty and risk premia increase again. Money will start flowing from risky regions into safe heavens, which means the liquidity crisis in the periphery accelerates. Thus, the interaction between the financial and the real economy will set off a negative feedback mechanism, which cannot be stopped until some form of borrowing resumes.

How can one break this vicious cycle? Budget policies could have stimulating effects, but only if the public debt is considered safe and unlikely to default. In most of the European crisis countries this is not a viable option. Policies must, therefore, concentrate on creating an environment that reduces risks and lowers liquidity preference for households, corporations and banks. The ECB has already done the maximum to accommodate liquidity preference in the Euro economy: it has cut interest rates repeatedly; it has implemented unconventional monetary policies by giving banks access to cheap and large amounts of liquidity for long periods; it has set up the OMT for the stabilisation of the sovereign

[13] See footnote 5.

bond market. However, it is unfortunate that the ECB had to step in to stabilise the market for government debt, while this should have been the task of governments. The proper way to stabilise the bond market for European sovereign debt would be the issue of Eurobonds. But national governments are by definition not in a position to assume responsibility for the Euro Area as a whole because they represent partial interests. Responsibility for the Euro Area can only be exerted by a European institution.

The ECB's actions have dealt with liquidity requirements, but they cannot fix the risks of insolvencies. In the real economy, insolvency risks will only come down when growth returns, so that firms and households are assured of the income necessary to service their liabilities. In order to restore the growth dynamic, the banking sector is a key variable. One of the dominant features of the crisis has been the disappearance of trust between banks. The interbank money market has dried out early on and banks borrowed or deposited excess liquidity at the ECB. While this preserves the integrity of the banking system in the short run, overcoming the credit crunch requires restoring trust and creditworthiness in the European banking sector. This is dependent on recapitalising weak banks, closer and tighter banking supervision and the creation of a banking union. Many European banks need to be recapitalised. The question is how this should be done. Shareholders may prefer deleveraging rather than see their equity diluted, but that drags out the credit crunch. A better approach would be to nationalise and/or Europeanise banks, for example by using funds from the ESM. But this is resisted by many governments because they do not wish to pay for a collective benefit. The same collective action problem has emerged with respect to banking supervision. After years of haggling, the European Council has finally decided to transfer responsibility for supervising large banks to the ECB, but many questions of practical implementation of the banking union remain. The persistent uncertainty dampens the propensity to invest in peripheral economies. Hence, it is the politics of the European Union that drives the crisis, not economics. To find ways of the crisis, the governance of the Euro Area has to be changed in profound ways.

3. An economic government for the Euro Area?

The economic governance of the Euro Area is handicapped by the inconsistency between centralised monetary policy and most other economic policies, especially fiscal policy, which have remained under the decentralised control of national governments. The Delors Report, which set up the blueprint to European Economic and Monetary Union in 1989, had already discussed the need for 'a coherent set of economic policies at the community and national levels' (Delors Report 1989: para. 25). With respect to fiscal policy, it noticed that:

> 'it would seem necessary to develop both binding rules and procedures for budgetary policy, involving respectively:
>
> - Effective upper limits on budget deficits of individual member countries (…);
> - The definition of the overall stance of fiscal policy over the medium term, including the size and financing of the aggregate budgetary balance, comprising both nationaland the Community positions.' (Delors Report 1989: para. 33)

While the first part of this quote has become the core of the SGP, the Maastricht Treaty did not transfer powers to the European Commission and entitle it to define or implement the aggregate policies described in the second part. As a consequence, Europe has been powerless in fighting the crisis.

It is not difficult to see what has been the obstacle to a more efficient policy framework, which could have accelerated the way out of the crisis: intergovernmental policy making has prevented the pursuit of optimal policies because the partial interests of member states dominate the common interest. Collective action problems have caused cooperation failure. Even when agreement for common action was reached, the way to get there was noisy and uncertain and the result resembled a Nash equilibrium, where each actor optimises his own payoff given what others do.[14] However, as is well known, Nash equilibria are not necessarily Pareto optimal, which means that at least some partners could be made better off by a different set of policies.

The typical example is the setting up of a bailout fund. When uncertainty hit financial markets and investors started to massively sell sovereign debt of the crisis states, a bailout fund could have stabilised financial markets. Early intervention would have calmed markets and stopped the crisis at minimum cost, but Europe's messy intergovernmentalism has prevented such benign solution. The insistence of the German government on the so-called no-bail out clause in the Treaty (TFEU para. 125) seemed, at first, to make it impossible to set up such a fund. However, when the danger of a systemic meltdown became imminent, German authorities gave in and the temporary EFSF was created. When this needed to be put on sounder institutional foundations, Germany again haggled to keep potential liabilities for taxpayers to a minimum. This clearly served the German Government, but not the Euro, nor European citizens in Germany and elsewhere. In a similar fashion, the rapid completion of the banking union with a single supervisor, a unified resolution mechanism and credible deposit insurance has been delayed again and again. The uncertainty created by these repeated game transactions has been extremely costly (Collignon et al. 2013). These costs are not only unavoidable in an intergovernmental framework, but in a monetary union they are also likely to exceed the benefits of monetary union in the short run. From a narrow point of view it may then seem justifiable to exit the Euro, but in a long run perspective, this would destroy the economic foundations of European wealth and welfare. Hence, the primary policy objective should be to set up a system which minimises uncertainty. This would require transforming the European Commission into a proper, democratically elected government.

It is important to understand why the traditional governance of intergovernmental voluntary cooperation does no longer work in European monetary union. We have said earlier that the process of European integration has generated many interdependencies and externalities, which have become particularly prominent in the Euro crisis. We now have to look at the nature of these externalities more closely. Externalities are related to the nature of goods people consume. The economic literature

[14] As Bergsten and Kirkegaard (2012) have pointed out: 'The euro area crisis (…) is a political crisis. Therefore, the most appropriate theoretical framework for analysing it is game theoretical concepts describing strategic bargaining among multiple actors, as found in Schelling (1966), or broader considerations of strategic actions as described in Liddell-Hart (1967)—not macroeconomic theories like optimal currency area theory (Mundell 1961), the debt sustainability theorem (Chalk and Hemming 2000), or other equilibrium-seeking modeling exercises aiming to restore full employment as soon as possible.'

distinguishes between private goods, pure public goods, club goods, and common resource goods (Collignon 2011). Because private goods are defined by exclusive property rights, they can be efficiently provided by the invisible hand of the decentralised market mechanism. By contrast, pure public goods are characterised by free access and unlimited benefit. For club goods, access can be restricted, but benefits are unlimited for club members. Common resource goods are freely accessible but limited in supply and benefit. It is well known that public goods are not efficiently provided by markets, because with free access individuals could free-ride on others who are willing to pay for them. But if every individual would behave this way, the public good would not be supplied at all. This is why political economists since David Hume have emphasised the need of setting up a government to ensure that public goods are supplied. Democracy is the mechanism that makes sure that the supply of public goods coincides with the collective demand of the people concerned.

In principle, it is also possible to provide public goods by agreeing to cooperate, if compliance to the agreement can be guaranteed (Ostrom 1990). However, the incentive structure to cooperate voluntarily is very different in the case of club goods and common resource goods. In the first case, cooperation yields potential benefits for everyone who contributes to the supply of the public good. In other words, cooperation is a positive-sum game. Cooper and John (1988) call the incentives to cooperate *strategic complementarities*. By contrast, common resource goods are defined by *strategic substitutabilities*, which means the utility augmenting action of one actor will lower the benefits for another. This is a zero-sum game. In this case, voluntary cooperation will fail and a centralised allocation mechanism must provide the public good.

In its early stages, European integration was characterised by the creation of European club goods. The Commission, as a custodian of common interests, had the task of ensuring that the governments of the Member States cooperated with one another. Yet, with the creation of the Euro, the dynamics of European integration have changed. Money is the general budget constraint of an economy, which means the supply of money by the central bank is limited under the mandate to maintain price stability. Hence, all public goods which are subject to the monetary budget constraint are effectively following the logic of common resource goods and strategic substitutabilities. Public debt is a typical example: access to the capital market is open to all, but the loanable funds are limited by the availability of central bank liquidity. If aggregate credit demand exceeds available funds, interest rates will go up which has negative consequences for borrowing anywhere in the monetary union. Hence, strong binding rules are necessary to prevent such negative externalities.

However, preventing negative externalities is one thing, generating positive ones is another thing. We have seen that in an economic crisis, discretionary policies may be needed to overcome the recession. Discretion is the opposite of rules. During the Euro crisis, the Troika was established to introduce a small degree of discretionary control into the application of stabilisation policies in crisis countries. But only democratic governments can act with discretion on behalf of the citizens they represent. The Euro Area's governance needs therefore more than just a set of (binding) rules to ensure sustainable debt, balanced growth and low unemployment. It needs a government and European democracy.

The idea of an economic government was first proposed by the French Prime Minister Pierre Bérégovoy during the negotiations of the Maastricht Treaty (Featherstone and Dyson 1999; Verdun 2003). For a long time it was opposed by the German government, partly because it looked as if France wanted to be that government. Nowadays, the idea is no longer taboo, given that Chancellor Merkel has publicly declared 'The economic government is us' (that is the European Council).[15] But an economic government for the Euro Area that consists of a council of member states and only implements Nash equilibria negotiated by autonomous nation states cannot be an efficient representative for the general will of European citizens. Without full democratic legitimacy by all citizens concerned, it is not possible to make fair and just choices in a zero-sum game. For that purpose, a government of the Euro Area must be democratically elected so that it can overrule the partial interests of partial constituencies in European nation states.

I have called the limited government for European public goods the European Republic (Collignon 2002b; 2011). The Euro crisis has revealed that the old ways of governing Europe no longer work. The republican paradigm points into a new direction. It focuses on public goods, Europe's *res publica,* which affects and concerns all European citizens. This approach does not recommend the creation of a fully integrated federal state. It simply seeks an instrument for preserving and improving the welfare of Europeans. Whether Europe is capable to seize the moment, I do not know. Emanuel Rahm, President Obama's first chief of staff in the White House, once made a candid point: 'Never waste a good crisis'. Europe' crisis is also an opportunity.

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