The World Economy

The World Economy (2015)
doi: 10.1111/twec.12230

Can the Euro Survive?

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WHILE it is early to mourn the euro, it would be unwise to ignore the magnitude and significance of the changes now taking place in the Eurozone. No doubt, the economic and financial problems in the Eurozone are serious and plentiful. The area is in the midst of multiple, frequently overlapping and mutually reinforcing crises. First, a fiscal crisis is centred in Greece but visible across the southern Eurozone and Ireland. Governments in Greece and Italy have been replaced in the space of a week because they were unable to guarantee the rapid implementation of economic reforms. Second, a competitiveness crisis is manifest in large and persistent pre-crisis current-account deficits in the Eurozone periphery and even larger intra-Eurozone current-account imbalances. Italy has accepted IMF and EU monitoring of reforms including deep liberalisation measures that had so far seemed out of reach, notably on labour legislation. Third, a banking crisis was first evident in Ireland but is now spreading throughout the Eurozone via accelerating concerns over sovereign solvencies. Spain, Ireland, Portugal and Greece are undertaking fiscal and structural adjustment measures – in Ireland, these are already paying off in terms of economic performance and credibility. However, one of the fascinating aspects of the European debt crisis has been the resilience of the euro, suggesting these fears are overblown. The euro is still a reserve currency, oblivious to the chaos ravaging European economies. As the Euro zone debt crisis enters a new uncertain year, the question about whether the euro can survive rises. This paper argues that the European crisis is political, and even largely presentational. The paper shows that the Euro can survive as the policymakers in the Eurozone still have various tools to use. These tools include creating exit rules, implementing new stabilisation rules and instruments, adopting new fiscal policy, introducing conditional Eurobonds, using inflation differentials and providing more independence to the European Central Bank.

1. INSTITUTIONAL FLAWS

The lack of confidence in the euro is first and foremost rooted in a crisis of fundamental institutional design. The economic and monetary union adopted in the 1990s comprised an extensive (though still incomplete) monetary union, with the euro and the European Central Bank. But it included virtually no economic union – no fiscal union, credible economic governance institutions and enough coordination of structural economic policies.

The euro's architects assumed that the single currency would act as a 'locomotive' and that deeper economic union would inexorably follow monetary union. Financial markets in the years following the euro's introduction seemingly assumed that a full economic union had nonetheless been achieved (a mistaken belief that self-congratulating European officials were often eager to cheerlead). And, they assumed that Greece could for years miraculously borrow

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at the same rates as Germany. So, there was no pressure on policymakers to implement required reforms during the boom years prior to the Great Recession.

With access to 'German interest rates', new Eurozone members enjoyed their own super-charged version of the 'exorbitant privilege' originally attributed to the USA by Valery Giscard d'Estaing. Large public and private-debt overhangs were built up in the Eurozone in the first years of the new currency and in the run-up to the global financial crisis in 2008. When the Great Recession finally hit, the economic contraction and loss of mispriced capital inflows into the periphery laid out the lack of true economic integration in the Eurozone and triggered severe market reactions that continue to this day.

There are two alternatives in front of European leaders. They could discard the monetary union, and in the process, reverse 60 years of gradual political and economic integration. Otherwise they could adopt a complementary economic union. For the turmoil, Europe is on its way to complete the original concept of an economic and monetary union. The European Union can emerge from the crisis much stronger as a result.

Policymakers in Europe know that the collapse of the Euro would cause an economic disaster and, thus, be politically unacceptable. Eurozone policy makers can address the current crisis and focus on the longer-term continuation and direction of Eurozone. The next subsections provide steps that can be taken to help the euro survive.

2. INSTITUTIONAL REFORM

Beyond the headlines about Greece and Italy, the central problem is a crisis of decision-making at the European level. At no point since early 2010 has the contagion been contained. This policy failure is astounding. Blaming the individuals would be unfair. In today's international standards, most of current European economic policy makers are reasonably competent, dedicated and honest. A significant part of the problem lies not in the economists in charge, but in the institutions.

At the core of Europe's predicament is an obvious mismatch: the key decision-makers at the European economic level are leaders whose accountability derives exclusively from national electorates. Most of them have no mandate to work for the common European good. The European Commission is mostly powerless, except in specific areas of autonomy such as trade and competition policy. The European Central Bank (ECB) is a federal institution but with limited scope of action. In the areas of fiscal and banking policy that have been made crucial by monetary union, there is no European executive branch.

Awareness of the mismatch leads to partial fixes such as leadership of the 'French–German couple'. Leaders must break this mould and empower individuals or entities to make decisions on behalf of European citizens and with adequate accountability to them. Some actions will require treaty change, others only a change of mindset. The latter category includes such vital moves as providing supranational guarantees to national deposit insurance schemes, to forestall the risk of bank runs in troubled countries. A single European body should provide a consistent assessment of all European big banks' capital positions as the basis for a credible recapitalisation plan. Member states should be prevented from using domestic financial firms as crutches to their own credit problems, to the peril of depositors and borrowers alike. In addition, treaty changes are required to provide proper accountability, starting with a different composition of the European Parliament to ensure that European citizens are equally represented, irrespective of their country. One relevant development is Ms Merkel's explicit endorsement on 9 November 2011 of significant treaty change as part of the solution.

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If the euro is to survive, a more federal framework for banking and fiscal policy is needed. But federations come in many shapes and sizes. The USA is an obvious reference point, but others may be more relevant. India, for example, shows that a continent-sized federation can be linguistically and religiously diverse and politically fragmented into myriads of local parties, but still democratic and resilient. Some European countries are more at ease with the federal principle than others – Germany more than France, to name only those two. An additional major difficulty is to make Eurozone-related decisions in a framework of EU institutions including countries that keep their national currency.

Such transformation of the nature of European integration can neither be imagined nor delivered by national leaders seeking national re-election, or by exhausted civil servants. An open public debate is part of the answer; for all its parochialism, Germany has gone further in this respect than most other Eurozone countries. But a mechanism is needed to implement institutional changes. A traditional intergovernmental conference is unsuited to the task, as diplomats are bound by old solutions and national positions. A more diverse group of national delegates could do better.

3. EXIT RULES

With the sovereign debt crisis spreading across Europe and in the run-up to the next EU Summit, there is no shortage of suggestions on how to save the Eurozone. Unfortunately, the majority of these suggestions have one of the following flaws. Either they address the long-term challenges without dealing with the short-term stabilisation problems or they address the short-term stabilisation issues at the cost of the Eurozone long-term sustainability (Delpa and Weizsäcker, 2011). However, there is one solution that would achieve both and provide added benefits. The Eurozone needs treaty provisions on ‘exit rules’.

Exit rules would decrease the probability of a break-up of the Eurozone by enhancing market discipline, increasing the political bargaining power of Eurozone members *vis-à-vis* the profligate countries, enhancing internal discipline in the profligate countries and reducing market uncertainty. Such exit rules in the Eurozone would reduce uncertainty and strengthen external market discipline, internal macroeconomic management, and the power of the Eurozone over profligate members. The notion, which is supported by EU officials and currently embedded in the EU legal framework that leaving the Eurozone is impossible may speak to political aspirations. This notion has been a key source of the imbalances within the Eurozone and is now at the core of today’s difficulties in resolving the crisis.

Such provisions are the legal equivalent of an implicit guarantee that member states will support each other to prevent an exit whatever the circumstances. This guarantee has given rise to a moral hazard, both for the markets and member states. It has also allowed a small country like Greece to hold the entire Eurozone hostage. This guarantee has transcended the Eurozone’s framework and is like a bomb with two fuses.

First, at the economic end, because of the guarantee, markets have for many years been taking far too many risks by treating, for instance, Greek and German bonds in essentially the same way. This behaviour has led to a reduction in market discipline and lower interest rates. It has also provided easy access to capital which had led countries like Greece to indulge in excessive fiscal spending. The resulting imbalances are now threatening the stability of the Eurozone.

Second, at the political end, the guarantee has shifted the political bargaining power to the profligate countries. It gave them leeway to pass part of their political and economic

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adjustment costs onto the rest of the Eurozone. Since the problems in Greece generate a negative externality for the other members, the Eurozone has little choice but to provide a bailout. As a result, there is no credible enforcement mechanism. Greece has again failed to meet its fiscal targets, and if the framework of the Eurozone does not change, it will fail to deliver yet again.

A political-economy analysis shows that exit rules would quench the burning ends of the fuses and would provide additional benefits (Fahrholz and Wójcik, 2011a, 2011b). First, if exiting the Eurozone were openly allowed, the markets would have no choice but to price non-zero probability into their risk assessment and thus better differentiate – not only in crisis times, but also in good times – country risk among Eurozone sovereign bonds. Then, external market discipline would intensify. Second, exit rules would increase the political bargaining power of Eurozone members *vis-à-vis* the profligate countries. Their power to enforce fiscal and structural reforms in the profligate countries would increase because the exit rules would become a bargaining chip in their negotiations with these countries. Their negotiation position and enforcement power would be increased. Third, exit rules would enhance domestic discipline because they would shift internal political economy incentives. In essence, they would increase the perceived costs of exiting in relation to the short-term political costs of adjustment. Then, domestic discipline would be strengthened. Fourth, exit rules would decrease market uncertainty, which would support the political and economic adjustment process. At present, nobody knows what the legal procedure for leaving could be and how the costs would be distributed. Clarifying these points would limit the scope for disruptive speculation with all its detrimental effects on the real economy. Financial uncertainty would also be mitigated.

Opponents of this solution may argue that merely initiating a discussion on exit rules would open up a Pandora's box at a moment when Europe is badly in need of stability. Quite the opposite is true. However, opening up such discussions would help stabilise today's mess because Europe's laggards would receive a clear message that the world has changed and there is a limit to the Eurozone's willingness to pay for their negligence. So, the pressure to deliver would increase.

Some may argue that there are no exit rules in the US monetary union, the blueprint for the Eurozone. Although true, such a view overlooks the unique nature of the Eurozone. It is a monetary union among sovereign states, and not a federal state with a common fiscal policy, like the USA. While increasing European political integration might be a step in that direction, it is naive to think that the Eurozone can make any substantial progress sufficiently quickly to avoid another blow somewhere in the near future. Europe is standing on the brink of a precipice between the undesirable now and the desirable future. It does not want to move backwards, but going forward is risky – this is when creativity is needed.

Some may also worry that exit rules would run counter to the political ideal of creating an irrevocable monetary union as the basis for a political union. But, just the opposite is true. Paradoxically, exit rules would decrease (and not increase!) the probability of an exit, or the break-up of the Eurozone. That case is because, as suggested above, spelling out the exit rules would give the Eurozone what it needs: enhanced market discipline, stronger enforcement power of the Euro zone, more internal discipline in the profligate countries and reduced market uncertainty.

The closest parallel to this positive feedback effect is the lender of last resort facility. A promise to provide unlimited funding to the banking sector decreases the probability of using public money because of the positive impact of such promise on the banking sector's stability. Evidence can be also found in political science and in the history of national states

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struggling with preserving their internal integration. Their experience suggests that when secession is not permitted, pressure for it rises. When secession is openly allowed, many would-be secessionists cease to press so hard for it. Exit rules would strengthen the Eurozone's cohesion and stability. They would address both the short-term and the long-term challenges, and their introduction is politically feasible.

4. CREATIVE FISCAL POLICY

The successful implementation of the recently established golden rule would overturn much of the existing economic governance in the Euro zone to become the main determinant of fiscal discipline. The intergovernmental treaty defines the golden rule as a structural deficit of 0.5 per cent of GDP or less. It applies to all Eurozone countries whose debts are not significantly below 60 per cent of GDP. The structural deficit tries to filter out temporary fiscal measures and fiscal evolutions that are purely due to cyclical changes in the economy. It therefore refers to over-the-cycle deficits. Yet, putting this concept into practice could prove difficult.

It is useful to indicate that the new golden rule does not correspond with the academic meaning of a golden fiscal rule, that is deficits can only be used to finance investments that are to the benefit of future generations (Artis, 2002). A major nuance to the golden rule is that it can temporarily be disregarded due to economic downturns that go beyond normal cyclical evolutions, or other major unforeseen events. These exceptions, along with the conceptual difficulties, could allow Eurozone countries to dilute the golden rule. However, the golden rule firm anchoring in national legislation and the German resolution to impose Eurozone-wide fiscal discipline is likely to counterbalance those loopholes. While the golden rule's success is far from evident, it thus seems presumptive to write it off as irrelevant.

How does the 'golden rule' compare with EU-level fiscal norms? The golden rule comes in addition to the existing EU fiscal norms (i.e. the 3 per cent deficit ceiling, the medium-term objective and the debt-reduction rule). In comparing these norms to the golden rule, it becomes clear that the latter will impose significantly stricter fiscal rigour, as shown in Verhelst (2012).

If the golden rule is effectively put into practice, then the 3 per cent deficit ceiling would play a different role than it played in the past. Instead of avoiding deficits surpassing 3 per cent of GDP in difficult times, Eurozone countries would be forced to have balanced budgets in normal times. This would render it much less likely that a deficit of more than 3 per cent is reached during economic downturns (Buti and Sapir, 1998).

The existing medium-term budgetary objective (MTO) is similar to the golden rule. The MTO requires member states to adhere to a country-specific structural balance that can range from a structural deficit of 1 per cent of GDP to a budget in surplus. In practice, future MTOs will have to be in line with the 0.5 per cent limit imposed by the golden rule. Eurozone countries could still decide to commit to an even stricter over-the-cycle budget. However, this commitment is not likely to happen often as 0.5 per cent is already a remarkably far-reaching commitment.

The role of EU-level fiscal norms will decrease considerably. They will serve to counter the inadequacy of a specific golden rule. In the likely event that a golden rule proves impractical or is diluted by a Eurozone country, EU fiscal norms can step in to restrict the country's deficits. In the Eurozone, fiscal norms will therefore evolve from their current normative function into a safety net only to apply when a golden rule proves defective.

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The stringency of the golden rule compared to EU fiscal norms raises questions about the soundness of its design. The golden rule risks obstructing public investments that address long-term challenges such as ageing and the shift toward a green economy. It seems preferable that the implementation of the golden rule considers public investments. If not, Eurozone countries will, perhaps sensibly, be inclined to circumvent their golden rule.

On the macroeconomic front, in the decade preceding the crisis, macroeconomic imbalances in the EU and within the Eurozone increased considerably. The warning signs were that current accounts of some member states increased to staggering deficits while for others current-account surpluses built up. External imbalances can be problematic but not necessarily worrisome if deficits/surpluses are natural responses to changes in underlying fundamentals and the related saving and investment decisions of households or businesses. For instance, countries in the catch-up phases often run current-account deficits by investing in building up the stock of productive capacity. This, in turn, increases the prospects of future income and ensures their ability to repay the borrowed capital. Similarly, countries with ageing population may find it opportune to save today, that is, run current-account surpluses, to avoid a drop in consumption in the future.

However, high and persistent current-account imbalances pose a policy challenge. They need to be tackled if they are driven by market failures or inappropriate policy interventions. In this respect, external imbalances might reflect other types of imbalances such as excessive credit expansions or asset bubbles. In these cases, the capital imported is not invested in productive activities that would enable the future repayment of today's incurred liabilities. Current-account positions can also be a sign of an imbalance if they reflect weaknesses in domestic demand.

Indeed, the growing imbalances in the EU and particularly in the Eurozone reflected unsustainable macroeconomic developments. Some member states saw their price and cost competitiveness improve markedly, while others lost competitiveness significantly. Price and cost competitiveness indicators, such as real effective exchange rates, document the increasing divergences in the EU and Eurozone. In addition, some Eurozone countries have shown a gradual deterioration in export market shares.

The growing external imbalances were reflected in a build-up of domestic imbalances such as excessive credit growth in the private sector, housing imbalances, structural weaknesses of domestic demand, and the inappropriate adjustments of wages to a slowdown in productivity. In particular, Greece, Spain, and Ireland experienced rather fast rates of growth which were to an important degree driven by domestic demand booms and expansions in non-tradeable sectors, notably, albeit not exclusively, construction.

As a result of this process, fuelled by low financing costs and increase in cross-border capital flow, resources were often channelled into less productive uses. The excessive credit expansions stimulated demand and pushed current account into deep deficits in some member states. Similarly, housing prices grew fast in many EU countries, in several cases developing into housing bubbles. Conversely, domestic demand in other member states has been constrained, in part, due to existing rigidities in product markets. These factors, together with mispricing of risk in financial markets, resulted in increasing current-account surpluses.

5. NEW STABILISATION RULES AND INSTRUMENTS

For a stabilisation instrument to be effective, three principles are keys. First, the instrument should be triggered following changes in economic activity, but its intervention should be

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halted as soon as no further changes occur, irrespective of the level at which the economy has again become stable. Otherwise, the instrument would perform not only a stabilisation function, but also play a redistributive role. Such an 'impurity' is typical for traditional fiscal policy measures, but should be avoided in the community context as it may perpetuate adjustment problems and induce transfer dependency. Second, the instrument should make its impact during the decline in real economic activity, and not afterwards, when the economy has stabilised or is already recovering. If the intervention affects the economy too late, undesirable fluctuations around trend growth will be amplified by government action. Timing is critical to the success of stabilisation policy, as well as hard to get right because downturns can be sharp yet relatively short-lived, and any discretionary instrument is subject to the problem of recognition and policy implementation lags, which can easily amount to more than half a year. Third, given the need for speed, the activation of the instrument should therefore be linked to an indicator, whose fluctuations form a close proxy for variations in real output, and whose measurement is accurate and quick.

Stabilisation is usually seen as arising through the effect of public financial transfers on private agents' incomes, and hence consumption. The stabilisation instrument should make a significant contribution to the income of individuals in the affected member states. On top of these requirements, the Eurozone stabilisation instrument should reflect three additional considerations. First, the instrument should only provide support in as much as the registered economic decline displays a clear country-specific dimension, rather than Eurozone wide shocks. Shocks affecting the whole monetary union should be responded to by fiscal policy coordination, national automatic stabilisers and ECB monetary policy, if price stability permits. Second, in keeping with the reasoning that the stabilisation instrument compensates for the loss of the exchange-rate instrument, and recognising that devaluation is not resorted for every dip in economic activity, the instrument should act as an insurance against economic difficulties. Third, the instrument should take the form of grants, not loans. Loans would not be appealing to Eurozone members with strong international credit rating who can smooth shocks with their own borrowing. Nor would they be useful to members with already high debt-to-GDP ratios as they would raise the country's level of indebtedness, pushing it further into the 'excessive deficit' zone. In essence, loans might undermine the credibility of the stabilisation goal.

In 1993, attempts to construct a minimalist federal fiscal reinforcement for a monetary union were rejected rapidly and comprehensively by the rich Northern nations. The likelihood of moving towards some fiscal counterpart to monetary union today remains slim. But would it be politically possible? Such a proposal would only relate to the Eurozone countries, and not to the 'out' countries (thus avoiding a UK veto). To reassure doubters it will not be the first step on a slippery slope to a 'transfer union' with all its 'moral hazard', rules of behaviour would be necessary.

The absence of any central fiscal authority to support the single monetary union led to the creation of the Maastricht criteria and Stability and Growth Pact. These criteria were badly designed, not only focusing unduly on public sector deficits, rather than on current-account deficits, but also having an incredible, and in the event unusable, set of sanctions. They are shortcomings, which stemmed from a number of implicit, and incorrect, assumptions. The first, and most important, incorrect assumption was that a private sector deficit in any country, matched by a capital inflow (current-account deficit), should not be potentially destabilising. The thinking was that the private sector must have worked out how to repay its debts before incurring them. The second misguided assumption was that, in a single monetary system, local current-account conditions not only cannot be calculated, but do not matter. The third

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assumption was that the public sector deficit of a member country is just as damaging when it is matched by a national private sector surplus, as by capital inflows.

Public sector debt can be redeemed in one of three ways: (i) by a revenue surplus of tax over expenditures; (ii) by inflating it away or (iii) by defaulting on it. Eurozone members forego the second option, so redemption requires a budget surplus or default. As taxes fall only on citizens, while default also affects foreigners, the nationality of creditors matters. If all debt is domestically held, the choice between tax and default converges; the choice is primarily a domestic matter. There will be indirect effects on other members of the monetary union, but so long as the domestic authorities choose the outcome with the greatest social welfare to their own citizens, that same choice will generally also be to the benefit of other members of the monetary union (yes, one could construct artificial counter-examples, but are they realistically likely?). In short, public debt and deficit rules must take account of the extent to which the debt is foreign held, and how far such deficits are matched by continuing capital inflows.

There should be an alternative to a new treaty: 'fiscal discipline board' and ECB collateral rules. The current proposal for a new treaty that would allow suspension of sovereignty is intrusive. The proposal is for some European Commission to take over fiscal policy in a country that runs afoul of the Stability and Growth Pact. The idea that a country loses fiscal policy sovereignty is inspired by IMF programmes. These programmes, however, are never imposed from outside. Countries apply to the IMF, on their own, and they negotiate conditions. This difference is not non-trivial.

A much better arrangement is possible without a new treaty. Currently, in its routine refinancing operation, the ECB accepts as collateral a wide range of assets. Most central banks accept mainly treasury bonds. The unusual arrangement of the Eurozone is an artefact of history. Because practices differed considerably among future Eurozone countries, the ECB decided to accept every asset that was previously accepted. The ECB has the authority to decide what collateral it accepts and it could decide to only accept treasury bonds issued by governments that exercise fiscal discipline. It would work as follows.

The ECB would ask an independent body to examine the fiscal policy framework of each member country. The body, call it the fiscal discipline board, would look for arrangements that adequately constrain member governments, for example the German debt brake or the Dutch coalition agreements. The ECB would bind itself to follow the board's judgment. A country that has not adopted arrangements deemed adequate, or that does not abide by its own arrangements, would face the consequences: high borrowing costs, possibly loss of market access. The presumption is that the situation would be promptly corrected.

Details need to be worked out: Who would appoint the fiscal discipline board? What means would the board have? Would there be a possibility of appeal? These matters are fairly simple issues, much simpler than the new treaty proposal. The key point is that this procedure does not call for a treaty. It does not tread upon sovereignty (fiscal discipline arrangements are left to each country; there is no threat of outside intervention or fine). And it should reassure the ECB which is currently rightly concerned by moral hazard. By relying on an independent board, the ECB would not have to pass judgment that can be construed as political. It would also reassert its independence, as it can decide on its own to adopt such an arrangement. This analysis implies that the Eurozone needs a wholesale reorientation of the stability conditions. They must be refocused towards concern with external debt, and deficit.

If a member country is in the position of the Japanese government, with a huge public sector debt, but fully financed domestically, with a current-account surplus and large net external assets, then its debt should entirely be its own concern, and not subject to control by

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any outside body, whether in a monetary union, or not. Of course, such greater attention to external, especially current-account, conditions needs to be more nuanced, since deficits, and external debts, incurred to finance tradeable goods production subsequently should provide the extra goods to sell to pay off such debts.

6. INFLATION DIFFERENTIALS

High debt levels, house price booms, less competitive labour markets are among the reasons for why some European countries are facing the wrath of the market. However, the reasons boil down to one measure – inflation. Using the inflation differentials as a guide can be the first step to seeing what countries need to adjust – and by how much.

The euro was created on the premise that no extreme country-specific imbalance would ever pose a threat to the stability of the common currency area. An intergovernmental covenant on the Stability and Growth Pact was considered to be sufficient. But recent crises in euro bond markets have highlighted the structural problems and the deficiencies of the eurozone. And, intra-Eurozone imbalances are not going to disappear overnight, and their re-emergence in different forms cannot be ruled out in the future. What can complement a new fiscal compact to ensure the future of the euro?

Quantitative restrictions on public borrowing are not enough. There is plenty of countries (i.e. Japan with a debt-to-GDP ratio of 213 per cent) with high deficits and debt that are not charged significant risk premia. Also there are countries (i.e. Spain with a debt-to-GDP ratio of 57 per cent) that have conducted their fiscal affairs prudently by international standards, but yet they are forced to pay high premia.

Another popular view attributes the Eurozone debt crisis to external deficits. Unfortunately, the cross-country correlation between risk premia currently charged and external deficits is just as feeble as that with public debt. In some cases, current-account deficits were associated with house price bubbles, and one can argue that excessive movements in asset prices could be responsible for the current problems. But, again, no stable relationship seems to exist between house price changes and the observed market premia.

There are many factors that could lead to imbalances. Focusing on one at the expense of the other factors could be misleading, and eventually costly. However, whatever the sources of the imbalances, they ultimately translate into real currency appreciation. In a currency union, this means rising inflation differentials. Whether or not excessive borrowing or lending comes from the government or the private sector and whether or not it is associated with bubbles, an imbalance raises demand and prices in one country above what is reasonably consistent with participation in a monetary union.

After the introduction of the euro, cumulated inflation differentials relative to Germany were as high as 21 per cent for Greece, 16 per cent for Spain, 14 per cent for Ireland, 12 per cent for Portugal and 8 per cent for Italy (despite the low Italian growth rate). Not surprisingly these countries are now in trouble. For comparison, cumulated inflation differentials across states in the USA rarely exceed 8 per cent over a period of 10–20 years.

The close connection between inflation differentials and crisis is no accident. Real appreciation is not simply about 'competiveness', as a distinct pathology from financial and fiscal stress. To a large extent, real appreciation is the single most important indicator of macroeconomic imbalances that encompass all of the above: structural issues keeping growth low, governments in a spending binge, banks taking excessive risk on expectations that taxpayers will end up paying the bills if things go wrong.

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That being so, why not use cumulated inflation differentials as a guide for pricing fundamental risk across countries? Fiscal integration on its own might not be sufficient; a more structural approach to the emergence of significant inflation differentials is also needed, particularly in the immediate future.

There is a sizeable consensus on the desirability of interventions (by the ECB or other EU institutions) to cap interest rates in Europe. Yet the design of these interventions runs into the constraint that caps should not translate into a subsidy to countries with weaker fundamentals. A policy of differentiated caps would do, but this raises the issue of which standard should be applied to differentiate them.

One solution can be to take cumulated inflation differentials as a reference measure of the adjustment required in each country. The empirical regularity stressed above about the correlation between spreads and cumulated inflation differentials would support operationally the idea of setting caps in line with current market debt prices, or some average over the past few weeks. In the current circumstances, the solution can be superior to leaving the determination of interest rate spreads totally to the vagaries of market forces. If the euro is not going to break up, there is no reason to pay investors a fee for their unjustified mistrust in the future of the currency.

7. INDEPENDENCE OF ECB

The ECB's independence should be preserved. Making the Eurozone's central banks independent is arguably one of the main European achievements of the last two decades. The importance of central bank independence is a lesson that the Bundesbank can be proud to have shared with everyone. With its independence guaranteed by the treaty, the ECB can be the most independent central bank in the world.

The May 2010 decision to contribute to the Greek bailout is worrisome, but not fatal. Why has the ECB taken that step? While not an excuse, there is a good, fundamental reason: the border between fiscal and monetary policy cannot, unfortunately, be clear-cut. This is a consequence of the policy dominance issue. It is a fact that there exists a unique public sector budget constraint that combines public debts, fiscal balances and seigniorage. Monetary independence exists when seigniorage is exogenous and budget balances are endogenous under all circumstances.

German history has shown how disastrous monetary financing of public debts can be, but that lesson is more subtle than just saying 'no'. Hyperinflation was the consequence of continuing monetary financing of the budget deficit, with no end in sight. Today the talk is about dealing with the existing stock of debts that cannot be refinanced on the market anymore. What is needed is a one-off guarantee by the ECB that sets a floor on these bond prices, and of course defaults to eventually regain market access. A guarantee does not mean actual purchases; most likely little will be needed and can be sterilised. The German precedent simply does not apply to the current situation.

More generally, there is a need to recognise that there are situations when a central bank cannot disentangle itself from the public sector budget constraint and must be the lender of last resort. Rather than denying that this possibility exists, the first thing to do is to adopt institutions that enforce disciple. And, the second thing is to accept that disasters may happen, and plan accordingly.

Within a country, it is understood that central banks may have to act as lenders of last resort for their governments, as in the USA and the UK, for instance. One may infer from

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Germany's interwar experience that this case will ultimately be inflationary, but this is not what many believe will happen this time around. Are they obviously wrong? This issue deserves further investigation.

Within a monetary union, things are even more complicated, if only because distributional issues arise. With adequate institutions in place in each country, the situation may still arise because of large-scale bank failures. Proper micro and macro-surveillance should make such an event unlikely.

In the Eurozone, the solution is to keep improving the system that has been put in place, by making the European Banking Authority independent and building a strong European Systemic Risk Board. There is a need for a sort of Bagehot Rule for emergency central bank support to governments. This time around, policymakers tried to invent rules as events have arisen.

8. INTRODUCING EUROBONDS

For months, economists have been arguing that Germany holds the key to ending the Eurozone crisis. Should it relax its anti-inflation stance and allow the ECB to inflate away sovereign debt? Or should it write a cheque of its own to the EFSF? Neither. There is a simpler solution, if only Eurozone leaders can see it. Eurobonds is the answer – but with conditions.

One dimension of the ongoing Eurozone crisis is the self-fulfilling high interest rates on some sovereign bonds that may lead to default. Eurobonds can be used as a tool to address this issue. Although they have been discussed for more than two years, during which the crisis has worsened, no progress has been made, perhaps because the idea seems too new, and because of the ambiguity of political positions. Yet the creation of a new instrument of public debt is not a new problem in history, and past experiences provide clear lessons.

There is no example in history of the rise of a political power without the simultaneous creation of its proper financial instrument of sovereign debt. The creation of a new financial instrument rests only on one basis, its credibility. For each of the past creations, that credibility was based on a central principle: the alignment between bondholders and both the tax revenues used to service the debt and the funding of the new debt. In other words, specified taxes were levied on which the service of the debt had first claim.

Eurobonds could be created with an *ad hoc* institution, the Euro Fund. Because of the multiple governments, the fund would have some features of financial intermediation, but would not be a bank. It would be an independent institution, with minimal staffing and policy role. In the current situation of the states' debts, its first initiative could be the purchase of 50 per cent of the public debt of participating countries. It would finance these purchases by issuing Eurobonds. The participating countries would be committed, by treaty, to devote a specific tax for payments to the Euro Fund. That tax would have first claim to the revenues of a country, prior to any expense of any sort. Each country would keep a separate balance at the Euro Fund and be charged the same rate on that balance. A surplus or deficit of the tax revenues would entail a variation of the debt of the country at the Euro Fund. The liability of a country at the Euro Fund would have a maximum of 60 per cent of its GDP. A country's public debt above that level would be financed like any sovereign bond. A country could keep a margin of safety below the ceiling for any emergency refinancing of its remaining sovereign debt and to prevent speculative attacks on its interest rate.

The Euro Fund would ensure the credibility of the Eurobonds. It would satisfy the political or constitutional concerns about transfers between the current states. At the same time, it

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would represent a true European project. The *ad hoc* tax would make each citizen more conscious about the implications of the public debt and the participation to the European project. Financial institutions could hold in their portfolio a safe asset that would have a large market. Right now, speculative attacks on interest rates can be successful because they select targets in fragmented markets. Interest rates in Italy are high because Italy would default if interest rates are high. They rise in Spain, France and even Germany because a default of Italy would have a major impact on their financial institutions. Eurobonds may not entirely eliminate contagion, but they would greatly reduce its possibility. In the current situation, banks hold in their portfolios bonds of their national state or use these national bonds as unstable collaterals to get euros. Hence, they are more vulnerable to the public finances of their country and the state is more vulnerable because of the need to bailout the banks if they fail. With Eurobonds, banks would be less affected by the instability of the public finance of their country.

Most countries in Europe now have a sovereign debt above 60 per cent of their GDP and would keep a sovereign debt that would be priced by itself in the market. The interest rate on these sovereign bonds would be higher than on Eurobonds and would depend on a country's commitment to fiscal stability. But because these rates would apply to a smaller fraction of a country's debt, any increase of the fiscal surplus would have a larger proportional effect on the service of that debt and therefore on its interest rate, thus enhancing the marginal incentive of governments towards fiscal stability. Furthermore, should a default occur, its side effects would be reduced because it would be expected to affect only a smaller fraction of a national debt.

The German Ministry of Finance could offer a two-year loan to the Italian government at 3 per cent above what it pays next year, if the Italian reform programme is showing visible signs of success, the spread could fall to 2.5 per cent and then to 2 per cent if progress continues. With backsliding, the cost would rise. This solidarity gesture would be highly profitable for the German taxpayer. The conditionality of the offer would keep the new Italian government committed to reform, aiding Italy's credibility as a Eurozone member. Conventional Eurobonds, meanwhile, with the same funding costs for every country but with risk collectively underwritten, would likely be a recipe for disaster. They would encourage lax fiscal policy, backsliding on reform and moral hazard. But conditional lending as illustrated above could be institutionalised in conditional Eurobonds.

For the investor, conditional Eurobonds trade at the same price for all issuing countries, but the riskier countries pay a premium, or 'spread', to the safer countries for underwriting their common debt issuance. Conditional Eurobonds, with spreads linked to the ratios to GDP of government debt and deficits, were first proposed by Wim Boonstra, chief economist of Rabobank, even before monetary union (Boonstra, 1991). Had they been part of Eurozone architecture, the current crisis could largely have been avoided, and even without fiscal centralisation.

Conditional Eurobonds would institutionalise, for all Eurozone countries, the simple example above of Germany lending to Italy. The conditional Eurobonds, issued on new borrowing, would be collectively underwritten by member governments of the Eurozone. Two design features would have to be settled: the formula that defines the spreads that each country has to pay into a central fund and the distribution of the payments resulting from the spreads to the guarantor governments. One can argue that spreads should be determined by relative unit labour costs and by relative government debt and current-account-to-GDP ratios. Including unit labour costs introduces incentives for improved competitiveness, promoting long-run economic growth.

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The proceeds of the payments could be distributed in several ways. In the simple example of a bilateral loan from Germany to Italy, Germany would retain the entire spread. With multilateral underwriting, all Eurozone countries would receive shares of the payments into the central fund. The shares would be determined by the size of their own borrowings and their spreads relative to Germany. Per unit of borrowing, less risky countries such as France would receive more than riskier countries such as Belgium, but less than Germany itself. In addition, part or all of the premium payments be retained in a central insurance fund against the possibility of a future debt write-down.

9. DO GOVERNMENTS AND THE ECB LEARN?

It is no surprise, either, that virtually every summit – each one presented as 'decisive' – produced 'comprehensive' solutions that crumbled in a matter of days. The real surprise is that markets started to buy into the official declarations and that it took them a number of days to reach the obvious conclusion that the proposals were neither decisive nor comprehensive. In the end, each summit has made the situation worse because it showed that policymakers were not able or willing to arrest the crisis.

The sight of policymakers apparently overwhelmed by the problems that they face is the most worrisome aspect of the crisis. Financial crises are complex events. They require an understanding of financial markets and of multiple equilibria. No one expects politicians to spontaneously master this kind of knowledge, but we would hope that they are adequately briefed and that their proposals are thoroughly evaluated before they are put forward. Unfortunately, it has not been the case, and the question is why.

One interpretation is that the Commission, which has technical resources, is kept out of summit preparations. A related interpretation is that the Commission is unwilling to be critical of governments. Either way would represent a tragic under-utilisation of resources that are sorely needed to solve the crisis.

Another interpretation is that the French President and the German Chancellor are not seeking out technical support because they are convinced that politics can solve any problem. Both are known to have such an inclination. Yet, they must have been repeatedly surprised that their 'comprehensive solutions' promptly fizzled out. One would expect that these sobering experiences eventually lead them to accept that the laws of economics cannot be discarded.

10. SHOULD THE FOCUS BE ON THE EURO OR BANKS?

The focus should be on saving the euro not banks. Throughout the European debt soap opera, European leaders have expressed their willingness to 'do whatever it takes' to restore stability and save the euro. However, too often, policymakers have in fact been 'doing whatever it takes' to serve the banks.

After initial denials, Europe's leaders have started to acknowledge that IMF Chief Christine Lagarde was right. Through their statements and decisions, policymakers are showing their agreement with her assessment in August 2011 at the Federal Reserve's Jackson Hole symposium that there was an urgent need for recapitalisation of Europe's banks (Lagarde, 2011).

This recognition of reality is good news. The bad news is the EU's bank recapitalisation is being handled in a way that will make a recovery from Europe's debt crisis more problematic

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than it needs to be. There are five concerns: incentives for deleveraging, absence of firm guidelines on dividends and executive compensation, omissions of a recession scenario and of an unweighted leverage ratio from the stress tests, inequitable burden-sharing during debt restructuring and insufficient measures to permit an escape from the adverse feedback loop between sovereign debt and bank debt. These concerns raise another, most disquieting, interpretation. Are the politicians captured by special interests?

A common thread of many decisions is that they aim at protecting banks. Clearly, no one wishes to see a banking collapse but if, as many believe, some deep bank restructuring is unavoidable, forbearance is highly counterproductive. The capture interpretation rests on a web of signals: the initial refusal of contemplating any sovereign debt restructuring, pressure on the European Banking Authority to conduct gentle stress tests, and the negotiation of public sector involvement with the world banking lobby leading to solutions that protect banks while providing little debt relief.

The ECB's actions have been equally disquieting. The small-scale bond purchases of the securities markets programme have repeatedly failed to quiet markets down. Tactically, the presence of the ECB in the market provides temporary relief. Yet, official statements that the latest intervention was a one-off have systematically undermined any strategic benefit that could be reaped. Most disturbing is continuous insistence on the primacy of the price stability objective, as well as concern with the transmission channels of monetary policy at a time when bond markets are in panic and the interbank market has stopped functioning. As he left the executive board, Lorenzo Bini-Smaghi has evoked 'quasi-religious discussions' within the Euro system. This episode would confirm the impression that the central bank is not focused on hard-core economic analysis and would explain why it does not seem to learn from past mistakes either.

The only kind interpretation is that the ECB and some politicians shrewdly want to use the crisis to achieve lasting fiscal discipline throughout the Euro zone. One idea is that acute pain will teach a lesson to countries that have always thought little of fiscal discipline. A better one is that there is need to go to the brink to make serious changes politically acceptable.

11. CONCLUSION

A number of economists question whether the common currency can survive. The Eurozone faces serious fiscal, competitiveness, banking, and financial problems. Yet for all the turmoil, fears of countries' repeatedly defaulting on their debts or the total collapse of the euro are vastly overblown. To sum up, the euro can survive. However, throughout this European debt and banking crisis, Eurozone leaders have expressed their determination to 'do whatever it takes' to restore stability and save the euro. But if one examines the stance the official sector has taken towards banks, it looks much more like Eurozone leadership 'takes (sheepishly) whatever its large banks do' – even when those actions are much more in the banks' narrow interest than in the wider public one. It is high time for a change.

The ongoing Euro zone crisis will not stop until key actions are taken. First, governments that lose market access must be bailed out in one way or another. For 'effectiveness' and 'moral hazard' reasons, the bailout should not be complete; instead it should encourage debt restructuring. On the 'effectiveness' front, countries with large public debts are unlikely to grow and therefore unlikely to be able to run down their debt-to-GDP ratio. On the 'moral hazard' front, defaults simultaneously reduce the debt burden and give incentives to governments to do what it takes to recover market access. Defaults would also help with another

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moral hazard, this time borne out of investors' beliefs that Eurozone governments never default.

Second, the bailout must be carried out by the ECB because the required amounts are unknown and could be huge. The total value of Eurozone public debts is about 9,000 billion euro. The European Financial Stability Facility (EFSF) can mobilise, at most 200 billion euro, and the IMF can be expected to put up a similar amount. Other countries will not add that much. Only the ECB can mobilise any amount of money as it becomes needed.

Third, banks must be recapitalised, if possible before some sovereigns default. The amounts needed are not based on the previous crisis – the consequence of the subprime disaster – but on the future crisis once defaults occur. If the banks cannot raise sufficient capital, the EFSF can provide the funds.

Fourth, addressing moral hazard requires the firm establishment of fiscal discipline throughout the Eurozone – and quickly. The treaty route is unlikely to lead anywhere.

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